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# Regulation

July/Aug 1982 AEI Journal on Government and Society

*The New International Regulation*

## BITING THE HAND THAT CURES THEM

**Kenneth L. Adelman**

## THE UN SYSTEM'S WAR ON THE DRUG INDUSTRY

**Harry Schwartz**

## ELECTRIC UTILITIES– NEXT STOP FOR DEREGULATORS?

**Irwin M. Stelzer**

Robert E. Mabley and Walter D. Strack on reforming trucking
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# Regulation

July/Aug 1982 AEI Journal on Government and Society


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REGULATION, *July/August 1982, Vol. 6, No. 4. Published bimonthly by the American Enterprise Institute for Public Policy Research.*


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*Subscription rates: $18 for one year, $34 for two years (add $12 per year for foreign subscriptions). Single copy price, $3.50. Information on bulk orders or multiple subscriptions available on request. Editorial and business offices: c/o AEI, 1150 17th Street, N.W., Washington, D.C. 20036. Send changes of address and all subscription correspondence to Circulation Department, c/o AEI, same address.*

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# Letters

*We welcome letters from readers, particularly commentaries that reflect upon or take issue with material we have published. The writer's name, affiliation, address, and telephone number should be included. Because of space limitations, letters are subject to abridgment.*

**Freedom of Information Act**

TO THE EDITOR:

Like the proverbial dog whose bark is worse than its bite, Antonin Scalia's article ("The Freedom of Information Act Has No Clothes," *Regulation,* March/April 1982) has a title more fierce than some of its specific comments. Nonetheless, his principal claim—that the act is unduly rigid, imposes excessive costs on the taxpayer, and produces very little benefit—deserves a response.

To start, we should put the cost issue in perspective. The Justice Department has estimated the annual cost of FOIA compliance at $57 million. That is an unsubstantiated figure; many observers believe it has been inflated by the agencies, which are not enamored of the act, and it may include budgets for press operations that would continue even if the act were repealed tomorrow. Even if the figure were accurate, however, it would not be a big item in the federal budget. The Defense Department plans to spend some $30 million more than that this year on military bands—which, to my knowledge, have not been the subject of any rigorous benefit-cost analysis recently.

Some of Scalia's criticisms are overstated because they focus on what the act *says* instead of how it *works*. It is true that the act does contain some strict standards on paper. In practice, however, agencies have greater leeway than the literal wording might suggest. For example, the time limits in the act (ten working days for answering a request, twenty for an appeal) are strict, but also essential, at least as a goal—especially if one believes in Parkinson's Law. Moreover, they can be extended. As a practical matter, they do not force agencies to drop everything (or, for that matter, very much of anything) in order to comply. The D.C. circuit court of appeals has ruled that agencies can ignore the deadlines so long as they are processing requests on a "first-come, first-served" basis. These days, it is not unusual to wait thirteen months for the Justice Department to process an appeal, and it is not the slowest agency.

If an FOIA case does go to court, the act requires that it be given expedited consideration, but so do over a dozen other statutes involving various cases from federal agencies. Moreover, in an FOIA context, expedition makes sense. Information can be a perishable commodity, and if a journalist has to go through three years of litigation to get a story, any ultimate victory he gains may be Pyrrhic at best.

As for the act's provision for sanctions against employees who arbitrarily withhold records, Scalia's comments are unfounded. Sanctions have never been applied and probably never will, since they are available only if a court orders the records disclosed. Thus an agency can litigate a case for years, turn over the records just before a decision is announced, and still avoid sanctions, no matter how egregious the withholding has been. How cost-effective is that type of litigation strategy to the taxpayer?

With respect to the act's direct costs, Scalia is correct that there should be more reliance on the price mechanism, but Congress should be careful to prevent agencies from using fees as a defensive weapon in cases where information would benefit the public. A useful solution would be to let an agency charge commercial requesters for the time its employees spend reviewing documents to see if they are exempt, in addition to the search and copying costs which it can now levy. At the same time, however, there should be a mandatory fee waiver if disclosure is in the public interest. Since at least 60 percent of all FOIA requests come from commercial requesters, the first reform would make the act more cost-effective and could cut down on corporate "fishing expeditions." The latter would ensure that journalists and others could obtain important data promptly without a lot of preliminary skirmishing over fees.

If Scalia's analysis of the act's costs thus seems overstated, his review of the benefits seems equally understated. Perhaps most troubling is his suggestion that the act is extraneous to its goal of government accountability. His evidence is the fact that the "major exposés" of the 1970s, from Watergate to the FBI and CIA, came about through "institutional checks and balances within our system of representative democracy."

The first problem with this argument is that it overlooks a number of FOIA disclosures that may not have toppled presidents, but that are still noteworthy. For example, the Better Government Association, a Chicago-based citizens' group, used the act to uncover some $2 million in seemingly fraudulent claims in a Small Business Administration bond guarantee program.

Such uses of the act are hardly unique. A 1981 study by the Library of Congress cited almost 300 articles which mentioned the act as a source, and there were undoubtedly other articles whose authors used the act but did not name it as a source. In May 1982 the Campaign for Political Rights released "Former Secrets," a compendium of 500 major disclosures under the act, a number of which spurred corrective action.

Regulation
AEI Journal on Government and Society
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Antonin Scalia
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Mark Nadel on Auto Insurance
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Scalia's criticism of "do-it-yourself oversight" seems to contain a hidden assumption that the "institutional checks and balances" of our system are a closed (or very limited) circle, at least between elections. The problem with this approach is that checks and balances are often triggered by a push from the outside, as the SBA example demonstrates. Without a mechanism such as the Freedom of Information Act to ensure participation from the press and public—and to call attention to matters that might not otherwise receive the attention they deserve—a vital link in the chain would be missing.

*Cornish F. Hitchcock,*
*Director, Freedom of Information Clearinghouse*

TO THE EDITOR:

I can add my own experience to Antonin Scalia's account. In January 1981 I filed an FOIA request for documents pertaining to the "PACE" consent decree signed by the Department of Justice on behalf of the Office of Personnel Management. In March 1982 I received a large package of materials from the department, along with a letter saying that certain portions of the documents had been withheld because they contained "privileged communications of the Department with client agencies." (It was, of course, precisely this information that I was after.) A typical document, dutifully sent me, read as follows:

Stuart E. Schiffer
Acting Assistant Attorney General
Civil Division
Department of Justice
Washington, D.C. 20530

Dear Mr. Schiffer:

Sincerely,

Arnold I. Melnick
Colonel, JAGC
Chief, Litigation Division

I should say that many months earlier I had made discreet inquiries at the OPM and learned what I wanted to know.

*Walter Berns,*
*American Enterprise Institute*

ANTONIN SCALIA responds:

I would guess that the $57 million figure for annual FOIA "compliance costs" is greatly *under*stated—that it does not include, for example, the cost of litigating the complicated exemptions or the time that high-level officials (who do not keep time sheets) spend in reviewing denials, planning litigation strategy, or screening classified files that only they can properly evaluate. Even so, to everyone except the ghost of Senator Dirksen ("$57 million here, $57 million there, pretty soon you're talking about real money!"), the direct costs are insignificant. The real damage consists in the disruption of important private and governmental activities.

I mentioned direct cost principally because that was the area in which congressional expectations ($100,000 per year) can most readily be shown to be at odds with subsequent reality; and also because most of the direct expense that is incurred is not only unnecessary but even counterproductive, since it eliminates a needed rationing mechanism. I gather Hitchcock substantially agrees with the latter point. Anyway, let me note for the record that I would consider it worth at least $30 million, plus the scrapping of the entire FOIA, not to have to march into battle to the hum of a kazoo.

I feel no need to apologize for addressing the act as it is written rather than the act as it is ignored. Those provisions so absurd that they cannot even be complied with are even riper for revision than the absurdities that are obeyed.

Finally, although I am not familiar with the specific instances of beneficial use of the FOIA that Hitchcock recites, I am willing to stipulate that his account of them is accurate. One does not have to favor the abolition of all "not guilty" verdicts to oppose the insanity defense. That is to say, my quarrel is not with the unquestionably sound concept of public access to government information, but only with the features of the 1974 amendments that produce the bizarre character of the current FOIA. The key question is not whether the act has benefits, but rather how many of those benefits would be forgone under a more rational access scheme. I think very few.

I will stand by the allegorical aptness of the title of my piece. If Hitchcock thinks its bark is worse than its bite, he may be mistaking what is barked and bitten at. ■

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# Perspectives
## on current developments

### Sugar Quotas: A Guide for the Economically Perplexed

As George Stigler wrote in these pages two months ago ("Economists and Public Policy," May/June 1982), there is no validity to the economists' standard complaint that the political world disregards the teachings of their science. To the contrary, he asserted, "if we look at any important economic policy of the state, we shall find that it takes account of whatever established knowledge economists possess, and perhaps of some that we do not possess." If economists do not like the results, it is usually not because the results were ignorantly produced, but because political actors are motivated by goals other than an abstract desire for efficiency, chiefly the goal of subsidizing some groups at the expense of others.

Stigler's point is well illustrated by the recent flap over the sugar import quotas imposed by President Reagan on May 5. If there is any government policy calculated to make economists feel slighted and put upon, it is the import quota. "Not year after year but generation after generation," to quote Stigler, economists have argued that import restrictions, as a means of helping domestic producers, are inferior to taxing a portion of the income obtained with free trade and using it to pay off the domestic producers directly. He might have added that given a choice between tariffs and quotas, economists will usually say that quotas are the less efficient alternative. Yet the Reagan administration has just embraced this worst of all protectionist schemes. Are the economists being ignored?

Probably not. Given the goal of subsidizing domestic producers—and given a few auxiliary goals of other sorts—the sugar import quotas may well have been the most direct and certain means available. Critics of the sugar quota decision may well dispute the administration's goals, but probably should not claim that it chose an inefficient way of achieving them.

Take, for instance, the possibility of raising the existing tariff on sugar. Since 1974, when the quota system in the old Sugar Act of 1934 expired, the United States has used variable tariffs to keep the price of imported sugar at or above a "market-stabilization price." The current stabilization price of 19.88 cents is derived under a complex formula from the support price of domestic sugar of 16.5 cents, which was written into Title IX of the Agriculture and Food Act of 1981.

However, there is a statutory limit on how high the variable sugar tariff can go. Under the current law, it must equal the sum of two components: (1) a flat per-pound duty that under the Trade Expansion Act of 1962 cannot exceed 2.8125 cents, and (2) a sliding fee that under section 22 of the Agricultural Adjustment Act of 1933 cannot exceed 50 percent ad valorem. Because of the effect on the second factor in this formula of the precipitous 1982 decline in world sugar prices, the variable tariff cannot now be raised enough to keep the market price above the market-stabilization price. Raising the tariff further would thus have required an appeal to Congress to change the laws, with the outcome uncertain at best.

The long-term welfare costs of tariffs on the economy are significant, but not very large compared with the total sums changing hands. In a 1980 Federal Trade Commission staff report, Morris Morkre and David Tarr estimated that the efficiency cost of the sugar tariffs would amount to $155 million over four years (in 1977 dollars). Since Morkre and Tarr assumed that a cost of $45 million would be incurred in shifting labor to other lines of work if the tariff were eliminated, they concluded that the net cost of the tariff to the economy was $110 million, or an average of $27 million per year.

For this relatively small sum in inefficiency loss, sugar tariffs allow the government to



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achieve a large amount of wealth redistribution from consumers to producers—as do quotas (though with a somewhat greater inefficiency loss). The reason is that sugar is quite price-inelastic: a large increase in price causes a small curtailment of demand. Assume, for example, that tariffs or quotas succeed in raising sugar prices here to the current market-stabilization price of 19.88 cents a pound and that the world price stays at 7.4 cents a pound, the average level recorded since the quota was announced. (In fact, the quotas have for the moment produced an even bigger spread between U.S. and world prices; as of July 9, the New York price was 21.8 cents and the world price 7.7 cents.) Then, assuming shipping costs of 1.5 cents per pound, the implicit subsidy to domestic producers would be just under 11 cents per pound, or more than $1.3 billion in all for the 11.6 billion pounds of sugar now produced domestically. (The difference would not be quite so large in practice, because world prices would rise if the United States reentered the market.)

This explains why a tax-and-subsidy program is unlikely to be taken seriously as an alternative to the tariffs and quotas. Aside from the political impossibility of openly proposing to give sugar growers $1.3 billion from the Treasury and then getting Congress to pass such a scheme, it is not even clear that the costs of running such a program would be cheaper than the $27 million dead-weight cost of tariffs or the doubtless higher cost of the current amalgam of quotas and tariffs.

Economists often declare that quotas are inferior to tariffs for two major reasons. First, not all quotas will be assigned to the lowest-cost foreign producers, leading to some inefficiency, and foreign countries will expend valuable resources jockeying in Washington for advantage. These costs are borne by foreign producers, however, and the latter may actually be of some benefit to this country, or at least to Washington officials and restauranteurs. Second, although fewer foreign producers will get to sell sugar to us, those who do will get a higher price than before, so that in effect a windfall value will be attached to their quota right. Since the quotas will be granted without charge to foreign countries, each of which will allocate them among its producers, the value of the quotas will represent a transfer from U.S. consumers to foreign producers. Some such countries will ship less than half as much sugar to the United States under the quotas, but will get half again as high a price for it—which, given that they can still sell the rest of their sugar on the world market, will make quotas more lucrative for them than free trade.

While it is too early to know for sure just how much the new quotas will be worth to those foreign countries, a likely minimum is $80 million in the second half of 1982. As before, we assume that sugar will sell for 19.88 cents a pound here and 7.4 cents a pound elsewhere. We also assume that tariff and ocean freight charges remain at the current level of 7.7 cents a pound and that the fourth quarter quota will be set at the same rate as that announced for the third quarter (840 million pounds). Under these assumptions the value captured by quota recipients will amount to 4.7 cents a pound, which, multiplied by 1,680 million pounds, will equal $80 million over six months or $160 million at an annual rate.

The actual figure will probably be higher than this for two reasons. First, the quotas may push the domestic price of sugar above the intended market-stabilization price. One reason to suspect that it may is that the 840-million-pound quota level announced for the third quarter of 1982 is far below the projected 1982 gap between domestic consumption and production of 7.6 billion pounds a year or 1.9 billion pounds a quarter (as taken from a June 1982 International Trade Commission report). Second, under the present legal formula, one component of the sugar tariff must drop when the market price rises above the stabilization price, reducing that item of expense to foreign producers.

Two American Enterprise Institute studies give some indication of how much sugar quotas were worth to foreign producers under the old Sugar Act. Ilse Mintz (1973) estimated the value at $398 million, and D. Gale Johnson (1974) estimated it at $326 million (both in 1977 dollars). The old quotas, however, may have been more stringent, and thus more expensive, than the present quota.

The question thus arises why the administration did not simply auction off the quotas, as it is permitted to do under the Trade Agreement Act of 1979. An auction would have been quite similar to a higher tariff in its effects, and the $160 million annual value of the quota



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would have enriched the Treasury instead of foreign producers.

The answer may lie in geopolitics. Specifically, the $160 million subsidy to foreign producers may be functioning in part as a substitute for the Caribbean Basin Initiative proposed by President Reagan in February. That initiative had hardly started, so to speak, when on May 19 the Senate Foreign Relations Committee voted 9-to-8 to transform it into a multilateral aid program run by the World Bank, a move that would afford the United States little control over the eventual disbursal of the funds. The sugar quotas may be an alternative, unilateral form of foreign aid: over a third of their value would now go to small countries in the Caribbean, Central America, and the West Indies, and they can be adjusted in the future to tilt even further toward these countries.

The Reagan administration could probably have achieved the same two objectives, subsidizing domestic producers and assisting friendly foreign countries, more efficiently if it could have imposed a higher tariff and used the proceeds for foreign aid. But that would have meant getting Congress to pass *two* new laws.

To be sure, it is a mystery to many why anyone except sugar farmers themselves would take such an interest in their welfare, since they do not seem so much more deserving than the much larger bloc of sugar consumers. But that is a reason to bring the goal itself into question, as distinct from the means of achieving it—which seem to have been selected in this case with all too much efficiency.

## A Charter for Bus Reform

Earlier this year, Texas International Airlines began to advertise what it called "bus fares." A flight from Baltimore to Houston, for example, cost $20 less than taking the bus. Not surprisingly, Greyhound found it had to lower its interstate fares to meet TI's, so it applied for permission to the Interstate Commerce Commission—which took only a week. Then it applied to the Texas Railroad Commission for permission to lower its *intrastate* fares—and that took two more months.

For all the problems the airlines are having, the bus industry is eager to join them in deregulation. Bus companies have improved their ridership and financial health slightly in the past two years, but they are still worse off than in 1970. New entry into the industry has been liberalized somewhat by the ICC. The difficulty of entry and the burden of subsequent regulation remain substantial enough, however, that illegal operations—what might be called "gypsy buses," mass-carriage equivalents of New York's "gypsy cabs"—now carry a significant percentage of all traffic.

The Bus Regulatory Reform Act of 1982 is intended to remedy matters. The bill passed the House last November as H.R. 3663, and a more liberal version, approved by the Senate Commerce Committee this May, passed the full Senate June 30 by a vote of 85 to 10. Observers are predicting that the House will go along with most of the Senate's changes. Although both houses have thus far resisted some strong deregulatory proposals put forth by the Department of Transportation and the Federal Trade Commission, the bill does make some notable changes.

- *Entry.* Several of the landmark decisions by which the ICC under Darius Gaskins eased entry into the trucking business also applied to buses. Licensing procedures, however, can still be a major barrier. For example, back in November 1979 when Greyhound challenged an application by Trailways Tamiami to operate between Atlanta and Orlando, Tamiami obtained 423 witnesses in favor of the new service and Greyhound lined up 390 witnesses against. After a nineteen-day hearing at which 327 witnesses testified, an ICC panel granted the application. Another year was taken up by Greyhound's unsuccessful appeal to the full commission (after which Tamiami was allowed to begin service) and yet another by its appeal to federal court, which failed in October 1981.

Under the Senate bill, carriers applying for new routes would still have to show that they met federal safety and insurance standards. For special and charter service and for scheduled service to unserved communities, such "fitness" is all they would have to show. (DOT wanted to leave it at that for all new entry.) Most carriers applying for scheduled routes, however, could be challenged by competitors, and would then face an added inquiry into whether granting their request is "consistent with"—instead of "required by," as existing law



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# In Brief–

**Public Confusion.** A nationwide Gallup poll conducted for the League of Women Voters and the Bendix Corporation suggests that the American public isn't very well informed about federal regulation. The poll found:

- Half of those interviewed could not name even one federal regulation that affected them or their family.
- Only 17 percent knew that the executive branch is responsible for making federal regulations; 47 percent thought Congress was.
- Opinion was split evenly on whether federal laws or federal regulations dealing with an issue are usually made first.
- More than half either could not name any difference between federal laws and federal regulations or else believed there was little or no difference between the two.
- Of those who did name a difference, the most popular response was that laws were mandatory, while regulations were optional.

There is not much sign that the regulators who have been fostering greater "public participation" in the rulemaking process have reached the real public.

**Carcinogen of the Month.** In the ever-growing list of substances, processes, and conditions linked to cancer, the newest culprit is stress —otherwise known as anxiety, nervous tension, jitters, and the heebie-jeebies. Dr. Vernon T. Riley, chairman of the Department of Microbiology at Pacific Northwest Research Foundation, says that recent experiments reveal that stress may at least promote, if not directly cause, the onset and spread of cancer in mice and other laboratory animals.

"Two groups of mice carrying a breast cancer tumor virus were subjected to different environmental conditions," according to an account in the *Baltimore Sun*. "After thirteen months, tumors had appeared in 60 percent of those mice placed in a noisy environment on rolling, open racks." Of the mice who enjoyed a calm, serene environment, only 7 percent developed tumors.

The discovery of this whole new category of carcinogens opens up exciting prospects for the regulation of stress. There could be national standards for the ambient level of frustration in factories, offices, even homes; state implementation plans for the reduction of nameless dread; and distinctions between naturally present stress and artificially added stress.

**Keep Those Complaints Rolling.** The Federal Trade Commission's antitrust arm wants to do something fast about a problem that becomes more pressing every day: the complaint shortage. "FTC: Bureau of Competition Begins Intensive Effort to Generate Complaints" was the way the Bureau of National Affairs headlined a recent story. According to a 57-page progress report, the commission "has recently undertaken an intensive experiment of short duration specifically directed toward testing case-generation strategies." The commission's Bureau of Consumer Protection is also faced with a steadily shrinking backlog of cases.

To stave off the ultimate fear of any bureaucracy—a lack of problems to solve—lawyers from each of the commission's bureau sections and regional offices are being assigned to the quest for new complaints. One must hope that the Defense Department does not have similar plans for generating its own business.

**Burned by the Freeze.** A General Accounting Office report released in March confirms what armchair government-watchers have long suspected: across-the-board federal hiring freezes haven't worked. Investigators found that the four government-wide freezes imposed since March 1977, three by President Carter and one by President Reagan, have hampered agency operations in various ways without making a significant dent in federal employment levels.

Agencies evaded the freezes by resorting to such time-honored techniques as hiring part-time and temporary employees and increasing their use of overtime and outside contractors. Others, according to GAO, adopted the less imaginative tactic of simply ignoring the orders. Of course, the Office of Personnel Management exaggerated the success of the operation: while it claimed that the first Carter freeze had cut permanent full-time employment by 16,800 between March and June 1977, GAO found that 7,099 of that reduction was due to the routine summer furlough of Defense Department teachers.

Not surprisingly, GAO also found evidence that hiring freezes disrupted agency operations. The resulting costs to the government included such items as lost tax revenues and uncollected debts.

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has it—the "public interest." The burden of proof would be transferred to the protester, and the legislative history indicates that "public interest" is to be defined more broadly than the traditional test of "public convenience and necessity." Still, Congress is really just replacing one ambiguous standard with another and hoping for the best.

More troublesome yet is language in the Senate-passed bill that would instruct the commission to consider such factors as whether the granting of an application "would impair the ability of [the incumbent carrier] to provide a substantial portion of the regular-route passenger service which such carrier provides." The committee reports express a pious hope that the parade of passenger witnesses at hearings will come to an end with the abolition of the "public convenience and necessity" standard. But surely there remain at issue under the proposed



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new standard questions such as whether the new carrier would divert existing riders from the incumbent's lines, thus possibly harming other small towns served by the incumbent—which is a call for the same old parade. Like the trucking reform act passed in 1980, the bill contains a cryptic provision that the mere diversion of business will not, "in and of itself," be grounds for denial. That, as well as everything else, suggests that how much deregulation comes about will depend on how the ICC chooses to apply the law.

- *Ratemaking.* The Senate bill would deregulate rates for special and charter operations and establish a zone of rate freedom for scheduled operations. (DOT wanted to abolish rate regulation entirely after three years.) It would also end antitrust immunity for collective setting of "single-line" rates (those which a company offers over routes in its own system) and some "jointline" or "interline" rates involving two or more companies. Collective ratemaking would still be allowed for across-the-board general rate increases, the industry's preferred method of fare-setting. (DOT wanted to phase out this type of antitrust immunity too.)
- *Federal preemption.* The Senate bill would permit, though not mandate, federal preemption of state control over the intrastate portions of interstate routes. As it stands now, if a bus route runs from Buffalo through Cleveland and Toledo to Chicago, the Ohio Public Utilities Commission can (1) prevent it from carrying local Cleveland-Toledo traffic; (2) allow it to carry such traffic, but at a lower fare than it charges for comparable route segments elsewhere; and (3) refuse to let the carrier abandon the local route even if it drops the rest of the interstate route. Under the bill, state control over pricing and exit on the local segments of interstate traffic would continue, but after unsuccessfully exhausting state appeals, bus companies could apply to the ICC for relief. The commission could grant the relief if the state's action posed an "unreasonable burden on interstate commerce." This compromise may have succeeded in making preemption more politically palatable to the states, but it means that regulatory relief would be available only after cumbersome procedures. (DOT wanted to preempt state regulation entirely.)

Considering Greyhound's current dominance of the market, it is noteworthy how little fear has been expressed that that company will monopolize the industry under deregulation. This may reflect a belief that smaller companies are fully competitive on thin, rural routes; or it may be a judgment based on the airline experience, where smaller carriers have done better than large ones under deregulation; or it may be just a shrewd calculation that Greyhound will not tempt antitrust enforcers by growing much larger. Whatever its basis, the confidence on this point seems well justified. In Florida, which abolished all intrastate transportation regulation two years ago, there has been no trend toward monopoly, and smaller bus carriers have prospered. (See Robert Mabley and Walter Strack, "Deregulation: A Green Light for Trucking Efficiency," p. 36.)

While the deregulatory features of the bus regulatory reform bill are limited, experience in other industries indicates that the camel's nose or domino principle has strong application to regulatory reform; after the first reform bill is enacted, pressures mount for further liberalization. Four years after Congress passed the Railroad Revitalization Act of 1976, it came back to pass the more liberal Staggers Rail Act. Since enacting reforms in airlines and trucking, Congress has debated, though not yet passed, an early sunset of the CAB, and it is expected to consider truck reforms next year, including a possible sunset of the ICC. The Bus Regulatory Reform Act should thus be seen as the first step in a process: while not as sweeping as the Airline Deregulation Act, it may contain the seeds of greater change yet to come.

## Antitrust and Travel Agents: Immunity with Reservations?

In many regulated industries—from shipping to public utilities—one of the benefits that it is within the power of the federal regulating agency to confer is immunity from the antitrust laws. Under some statutes, such as the Shipping Act, the agency's power to confer that immunity is explicit; under others it derives from the so-called doctrine of primary jurisdiction, which gives the agencies the first and often final say over the extent to which their substantive statutes implicitly modify the normal "rule of reason" standards of the antitrust laws.



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When regulation is eliminated through repeal of the substantive statute, the antitrust immunity of course terminates as well. But in the current era of deregulation through agency refusal to use continuing statutory authority, there is a possibility that the previously regulated industry may, so to speak, keep the *quid* even though it has gotten back the *quo*. That is to say, an agency may eliminate most or all of the constraints that it had previously imposed, but still continue the antitrust immunity. On June 1, a CAB administrative law judge recommended precisely this course with respect to the airlines in their relations with travel agents; the CAB will review that decision later this summer.

Three years ago the CAB initiated an investigation of the Air Traffic Conference (ATC)/ International Air Transport Association (IATA) "conference" system of accrediting travel agents. Under that system, airlines collectively set and enforce accreditation standards for the nation's 18,000 travel agents. Some of these standards are of the sort frequently encountered among professional groups: agents must meet financial requirements, have a certain number of years of experience, and maintain certain facilities. Airlines, for their part, agree not to pay commissions to unaccredited agents. (While the international agreements do not contain such a provision, there is enough overlap between the two conferences that the effects have been similar.)

In the conferences' scheme of things, the role of the travel agents is to "promote and sell" air transportation, with the emphasis on "promote." The agreements are therefore intended, as James C. Miller III testified in the proceeding (before he joined the Reagan administration), to "reserve to air carriers 'easy' sales and to confine to travel agents only 'difficult' sales." For instance, a large chunk of sales for which customers already know where and when they want to travel is reserved for the airlines by an IATA rule that prevents agents from locating in or near airports. Similarly, business travel departments, which plan flight schedules and write tickets in virtually the same way as travel agents, cannot be accredited as agents (and thus cannot receive commissions) because of a rule forbidding agents from doing more than 20 percent of their business with a company under the same ownership. Deregulation may have weakened the effectiveness of this rule, since the business travel departments may now bargain for special discounts, although they cannot share in the bargaining power of the agents.

That this system successfully divides "easy" from "hard" sales is evidenced by the fact that the cost to airlines of selling tickets directly is only 3 to 5 percent of the purchase price, while the commission they pay to agents is on the order of 10 percent. Customers, of course, pay the same rates whether or not they require help from travel agents—so that those who do need such help are in effect subsidized by the "easy" customers who do not.

Naturally this redistributive effect is accompanied by some dead-weight loss: the ATC/ IATA agreements prevent airlines from exploring promising new ways of marketing tickets. World Airways, a major carrier that does not belong to ATC, has sold tickets through Ticketron outlets since 1978. Such "no-frills" retailing, reflected in lower fares (as it is in World Airways' case), can offer significant savings to passengers who already know where and when they want to go, just as discount stockbrokers with no research departments have saved "do-it-yourself" investors millions in recent years.

The airlines and agents argue that antitrust immunity is all that stands between the travel business and utter chaos. British Airways, for instance, stated that "the very existence of [British Airways] in [the United States] in anything like its present form is dependent upon the sales representation we receive under the IATA program." The relationship between airlines and agents, they argue, rests on the trust engendered by the common accreditation system. Agents are entrusted with blank ticket stock, accepted by all member airlines, that could easily inflict large costs on airlines if misused. Moreover, if individual airlines had to accredit their own agents, airline travelers would ultimately be burdened with the higher costs, and in addition would have no assurance that a ticket written on one carrier could be used ("interlined") on another.

Administrative Law Judge Ronnie A. Yoder's decision reflects these concerns. Subjecting the system to the antitrust laws, he argues,

> would undermine intercarrier confidence in the travel agent network and in the reliability of interlining . . . threaten the com-



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> petence and professionalism of the travel agent industry as a whole [and] reduce the availability of travel agents.

After listing a series of "what ifs" concerning the possible misdeeds of "irresponsible, incompetent or careless" travel agents, Yoder concludes:

> Certainly nothing in this record would justify risking the current air transportation marketing system in reliance on assertions that the Board should disapprove the agreements and trust other market forces to solve the resulting problems "in the long run."

References to things like "intercarrier confidence" are reminiscent of the CAB of many years ago.

Yoder's 200-page decision notes that under the agreements airlines are allowed to sell tickets to resellers (who, unlike agents, assume the risk of unsold inventory) and recommends disapproving the IATA curb on agents' locating near airports, as well as some other clearly anticompetitive conference standards. But it is ambiguous on the issue of retailing innovations. The most troubling passage, to deregulators, is one that discusses the role of Ticketron and notes that "the distinction between agent and non-agent status may be difficult to resolve in any given case." Relying on Ticketron's own assertion that it would be "economic insanity" for anyone to try to compete with it for the no-frills market, the decision recommends that "the Ticketron ticketing operations . . . be incorporated as a *sui generis* exception" to the rule that airlines may sell tickets only through agents. Thus a regulatory agency that many people thought dead is to consider *creating* a national monopoly in a potentially important market: no-frills airline ticket sales.

Permitting all airlines to sell through other Ticketron-type outlets, by itself, may not lead to much innovation. For one thing, the antitrust immunity would still permit the ATC to exclude such outlets from the clearinghouse that settles carrier/agent accounts, thus forcing those outlets to adopt costly special arrangements for payment. Even ending antitrust immunity completely might not change matters drastically. Indeed, stripped of the more restrictive provisions—those that the courts would interpret as a collective refusal to deal—the agreements could probably continue in much their present form. Critics of the conference system also allege that the agents can enforce their will informally: any airline that tried to sell tickets through other outlets might experience a sudden drop-off in its sales through agents. Since agents account for well over half of total airline sales, such a threat might suffice to prod a straying airline back to the fold.

The apparent power of agents to discipline airlines—even though it is the latter who write the rules for the system—illustrates the difficulty of determining just which side, in a bilateral monopoly like ATC/IATA, has the real market power. Under regulation, the airlines used the ATC/IATA conference system to set commissions collectively. Since commissions were allowed to float in 1978 (for international routes) and 1980 (for domestic routes), they have risen rapidly, from around 7–8 percent to about 10 percent today. At the same time, there is evidence that travel agent costs have not risen dramatically—which may indicate that the old system was protecting the airlines from the market power of the agents, rather than vice versa.

## Active Judges and Passive Restraints

The June 1, 1982, decision of the U.S. Court of Appeals for the District of Columbia Circuit in the so-called airbag case, *State Farm Mutual Automobile Insurance Company* v. *Department of Transportation,* is certain to be one of this year's most significant judicial pronouncements in the regulatory field. The court's specific holding—invalidating NHTSA's repeal of the automobile "passive restraint" requirements promulgated by the Carter administration—is of immediate importance to auto manufacturers, insurers, and buyers. But of even broader concern is the basis of the holding, a theory of judicial review and of required administrative process that may impede all deregulatory initiatives by agencies.

The controversy underlying the case is so old that it no longer excites. Department of Transportation Standard 208 was issued in 1967, requiring seat belts in all cars. Finding that people did not use the darned things, the department began a new rulemaking in 1969 to consider whether to require "passive restraint



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systems," defined as protective systems that require "no action by vehicle occupants." That standard was issued in 1970. It was successively modified many times thereafter, the effective date being pushed back with each modification so that a passive restraint requirement never did enter into force. (What did enter into force, in Ralph Nader's finest hour, was the interim requirement—until manufacturers could tool up for passive restraints—of an "ignition interlock" device making it impossible to start the vehicle unless seat belts were engaged. That much-hated feature, and its cousin the continuous buzzer, were banned by Congress in 1974.) Shortly before the 1976 effective date, Ford administration Transportation Secretary William Coleman began a new rulemaking to reconsider the issue, and ultimately suspended the requirements in favor of a proposed "demonstration project" involving up to 500,000 cars. Four months later Coleman's successor, Brock Adams of the Carter administration, reopened the rulemaking, and subsequently issued a new mandatory passive restraint rule with an effective date beginning (for large cars) in the 1982 model year. Once again, however, the promised day never came. Adams's successor, Drew Lewis of the Reagan administration, reopened the rulemaking once again in February 1981; two months later NHTSA ordered a one-year delay in the application of the standard to large cars; and in October 1981 it promulgated a new standard eliminating the passive restraint requirement altogether. That action was the subject of the present case. Four aspects of the court's lengthy opinion merit comment:

**The Variable Standard of Review.** The Administrative Procedure Act (APA) sets forth only one standard for judicial review of ordinary agency rulemaking. Agency action may be set aside if it is "arbitrary, capricious, an abuse of discretion or otherwise not in accordance with law." Where Congress wants stricter review, as it does under a number of regulatory programs, it specifically provides that the rules must be supported by "substantial evidence." (Never mind that it is hard to see why a rule would not automatically be "arbitrary" if there were no substantial evidence to support it; it is absolutely clear that Congress *intends* the "substantial evidence" test to be stricter.)

In the air-bag case, however, the D.C. circuit follows several recent appellate decisions in asserting that the "arbitrary and capricious" test itself is not one but many. (As the court's opinion puts it, "the same verbal standard of review should be given different scope in different contexts.") This principle may not be as transcendent as the Trinity, but it is at least as mysterious; it defies not merely language, logic, and legislative history, but even a Supreme Court opinion that rejected a similar attempt to give variable content to the "substantial evidence" test.

The only thing that can be said in favor of the D.C. circuit's position on this point is that it is true. There is not the slightest doubt that the "arbitrary and capricious" test, like the "substantial evidence" test, the "preponderance of the evidence" test, the "reasonable man" standard, the "probable cause" requirement, or any other decisional criterion that the mind of man or lawyer has been able to devise, is *in fact* stretched to varying degrees, in one direction or another, as the needs of reality and the equities of "hard cases" seem to require. That is, some would say, part of the play in the joints that any legal system must possess. But courts normally have the good sense and decency to lie about it, recognizing that in this context, as in many, hypocrisy is the beginning of virtue. With formal acknowledgment of a multiplicity of standards, occasional stretching of the law is replaced by regular eccentricity and, ultimately, complete disregard of the legislative command. We doubt that the Supreme Court will support this explicit rewriting of the APA.

**Deregulation Subject to Strict Review.** Still, what threat could such a principle possibly pose to deregulation? Even if the "arbitrary and capricious" test turns out to be a sliding scale rather than a standard, surely an agency's elimination of burdens upon private parties—like an agency's failure to impose burdens in the first place—must fall within that portion of the scale giving the administrator broadest leeway, and the courts the narrowest scope of review.

Not so. The key to the scale, it turns out, is the existence of "danger signals"—alarum bells audible to the trained judicial ear—which convey the message that strict court scrutiny is



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needed. One of these klaxons is "sudden and profound alterations in an agency's policy." The court acknowledges that it makes more sense for this particular bell to ring in the case of adjudication than rulemaking, since general adherence to precedent is the essence of a fair and responsible case-law system. But even in rulemaking, the court asserts, sudden and abrupt change is a danger signal because it suggests "that the will of Congress is being ignored." This reasoning is not explained, which is unfortunate since it is counterintuitive. The institutional inertia of administrative agencies being a well recognized and thoroughly documented phenomenon, one would expect that, *au contraire,* a sudden and abrupt change of policy is more likely an indication that Congress *is* being listened to!

The court's opinion seems to indicate that the mere occurrence of an abrupt change in policy is itself enough to create a suspicion that Congress is being ignored, which suspicion is itself enough to trigger strict scrutiny. The opinion goes on, however, to a particularized examination of the "will of Congress" with regard to passive restraints—a will that the court discerns not in the language or legislative history of the statutory text under which NHTSA was acting, but in Congress's failure to overturn the passive restraint rule by legislation or legislative veto, and in the legislative history (or, more precisely, nonlegislative history) of proposals *almost* enacted which would have mandated passive restraints. "Reading this legislative history as a whole," the court concludes, "suggests a congressional commitment to the concept of automatic crash protection devices . . . that we may not take lightly. . . . [W]e conclude that rescission of the standard must be subject to 'thorough, probing, in-depth review' lest the congressional will be ignored."

One is tempted to criticize this portion of the opinion merely on the ground that it is invalid to rely on scattered statements in the course of legislative nonaction as an indication of legislative intent. Or on the ground that, to the extent congressional intent never embodied in a law has any relevance (which perhaps should be not at all), then surely it is only *present* congressional intent, which in the case at hand is most clearly indicated by the failure of either house to take any action opposing the highly publicized and controversial repeal of the passive restraint requirements. But let all that go. The *real* novelty in the concept of violation of congressional intent as a "danger signal" is the consequence that the court attaches to it. If there really was, in any valid and operative sense, a "congressional commitment to the concept of automatic crash protection devices," then surely the consequence should be not an increase in the D.C. circuit's ability to scrutinize the reasonableness of NHTSA's repudiation of that concept, but rather—quite simply—invalidation of NHTSA's action, reasonable or not. But of course the court does not assert the existence of any such operative congressional action—merely that "the [passive restraint] standard has come as close as an agency-made regulation can come to being affirmatively endorsed by Congress, without Congress actually having done so." Only a sound sense for the hackneyed prevents one from mentioning pregnancy. This notion of an ineffable, "almost," congressional will, not strong or clear or legitimate enough to bind an agency outright but somehow effective to make an agency's action smell bad and thereby expand the scope of judicial review, is extraordinary.

**Shifting the Burden of Proof.** It is not clear whether the last two novelties of the air-bag opinion result from the application of a heightened standard of review on the basis of the theory just expounded, or rather are totally independent principles that would be applied to any rescission of a rule, even when "thorough, probing, in-depth review" was not indulged in. The first of these is the principle that a rescission is arbitrary unless the agency establishes that the preexisting rule will not be desirable. It is not enough, according to the D.C circuit, merely to establish that there is no reason to believe that the preexisting rule *will* be desirable.

In the air-bag case, this principle is applied to the crucial question of whether the passive restraint standard would result in increased use of seat belts. Although automakers could have met that standard by equipping cars with either automatically engaging ("passive") seat belts or air bags, NHTSA concluded (and the court did not dispute) that the overwhelming majority of new cars would be equipped with the former. It also concluded (and the court did not dispute) that the standard would be



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worthwhile only if the passive belts (which under the standard could be detachable) would increase nationwide seat-belt use by at least 13 percentage points, from 11 percent to 24 percent. Data on the use of passive seat belts in VW Rabbits and GM Chevettes showed an increase of more than this amount, but NHTSA found it impossible to generalize from those data for a number of reasons: (1) the data pertained to subcompact cars, where belt usage is always higher, (2) Rabbit owners are typically better educated and more affluent than the population at large, (3) some of the models had certain coercive use features not required by the standard, and most important, (4) the owners voluntarily paid for the passive belts and so would be less likely to detach them.

The D.C. circuit did not contest the unreliability of the data on increased use, but that was still, it said, no justification for abandoning the passive restraint rule, because *"the question is not whether evidence shows that usage rates will increase by the necessary amount, but whether there is evidence showing they will not"* (emphasis added). Without such evidence, the rule might be temporarily suspended or amended, but "the regulatory program [could not] be abandoned altogether."

This part of the court's opinion is lent some credibility by what might be called the procedural inertia of our laws, which favors the regulatory status quo, with no bias toward either the regulated or the unregulated state. That is to say, neither may an unregulated field be regulated, nor a regulated field be decontrolled, without conducting a rulemaking proceeding. As far as the Administrative Procedure Act is concerned, the promulgation of a rule and the repeal of that rule are equivalent.

But parity of process does not necessarily entail parity of substance. Granted that a rulemaking proceeding must be conducted to impose regulation and to eliminate regulation alike, it does not necessarily follow that in both types of proceeding the burden of justification rests on the proponent of change. As far as the *substantive* inertia of our laws is concerned, that favors not the status quo but private autonomy, whether or not that is what the status quo prescribes. That is to say, private freedom can neither be constrained *nor continue to be constrained* without good reason. The D.C. circuit acknowledges this. "Implicitly," it says, "the perpetuation of a regulation involves a decision that its continuation is worthwhile, and reasonable decisionmaking requires that this too be supported by reasons."

If, then, all of the evidence in a proceeding to consider the revocation of a rule fails to establish the utility of the rule, why must the agency continue to search further, for evidence that positively *proves* the rule to be ineffective? There might be reason for such a requirement if the evidence to be considered were within the exclusive control of the agency—so that a malevolent agency bent on scuttling a desirable

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rule could do so by simply failing to introduce into the proceeding any demonstration of the rule's beneficial effect. But that is not the case under the APA. NHTSA could not have prevented *any* person from introducing proof that detachable passive-restraint belts would increase seat-belt usage the necessary 13 percentage points; it found (and, in the court's judgment, reasonably found) that no one had done so. Given this protection against malevolence, and if it is indeed unreasonable to continue a regulation that is not affirmatively found to be useful, how can it possibly be considered "arbitrary" to revoke a regulation that the agency properly finds no evidence to support? Either the court's concession of the presumption in favor of private autonomy or the court's requirement of proof of nonutility must be wrong.

**Mandatory Consideration of Other Regulatory Alternatives.** Even if an agency can sustain the burden of proving that a regulation will not do any good, it is still not yet out of the woods. According to the D.C. circuit's opinion in the air-bag case, it cannot then simply walk away and leave the area (shudder) unregulated. Just as President Reagan's Executive Order 12291 requires agencies to regulate only incrementally, choosing in each case the "least onerous alternative" that will produce the desired result, the D.C. circuit opinion creates a rule of incremental *de*regulation—allowing an agency to revert to the unholy state of utter deregulation only when all more onerous alternatives have been exhausted.

Thus, said the D.C. circuit, even if NHTSA *had* proven that the existing rule would *not* increase seat-belt use by 13 percentage points, it would not have been justified in repealing the rule, but would have had to consider other options, such as (1) requiring the seat belts to be nondetachable, and (2) eliminating the seat-belt option entirely, and requiring air bags for all cars.

This portion of the court's opinion has intuitive appeal. When regulation of a certain type or at a certain level is seen to be unjustified, surely a rational decision maker will not immediately abandon regulation entirely, but will first search for other alternatives to achieve the same result. And failing to do so can properly be called "arbitrary."

This assumes, however, that the decision maker *wants* to achieve the goal which the regulation sought to achieve, or that he has some obligation to continue the pursuit of that goal. And that is the crux of the matter. The keystone of this portion of the opinion is the court's assertion that "if NHTSA did not believe the standard as written would fulfill the standard's goals, its foremost obligation was to consider whether an amended standard could." If this refers just to the statutorily prescribed goal of highway safety, it would of course be correct. But it does not. It refers to one particular means of achieving that more general goal—namely, the prescription of effective passive restraints. At that level, it is not self-evident why the goal pursued by an earlier administration must be pursued by its successors.

Generally speaking, regulators have no obligation to implement particular modes of regulation or to focus on particular segments of commerce within their statutory jurisdiction. If, for example, the Federal Trade Commission chose never to devote its attention to used car dealers, it is most unlikely that any court would say it had to do so—even if a plaintiff was prepared to prove that this area contained more abuses and was more in need of regulation than other fields the commission had already entered. Similarly, it is unlikely that any court would have forced NHTSA to consider imposing passive restraints if NHTSA had never done so. In other words, the establishment of intermediate regulatory objectives and targets leading to the prescribed statutory goal is largely (in the nonpartisan sense) a political judgment. What the air-bag decision asserts is that the *dis*establishment is not. To personify the matter: we can decide to pursue a "passive restraint" approach to automotive safety by electing Jimmy Carter, but cannot abandon it by electing Ronald Reagan.

It is difficult to understand why the court felt constrained to create this asymmetry. At most, the APA requires that the particular rule be determined to be not demonstrably effective before it can be revoked; nothing requires that a rulemaking then be conducted to fill the resultant void. At that point the choice between passive restraints and other approaches could have been recommitted to the political process.

Perhaps the court's position on this point is not quite as sweeping as has just been sug-



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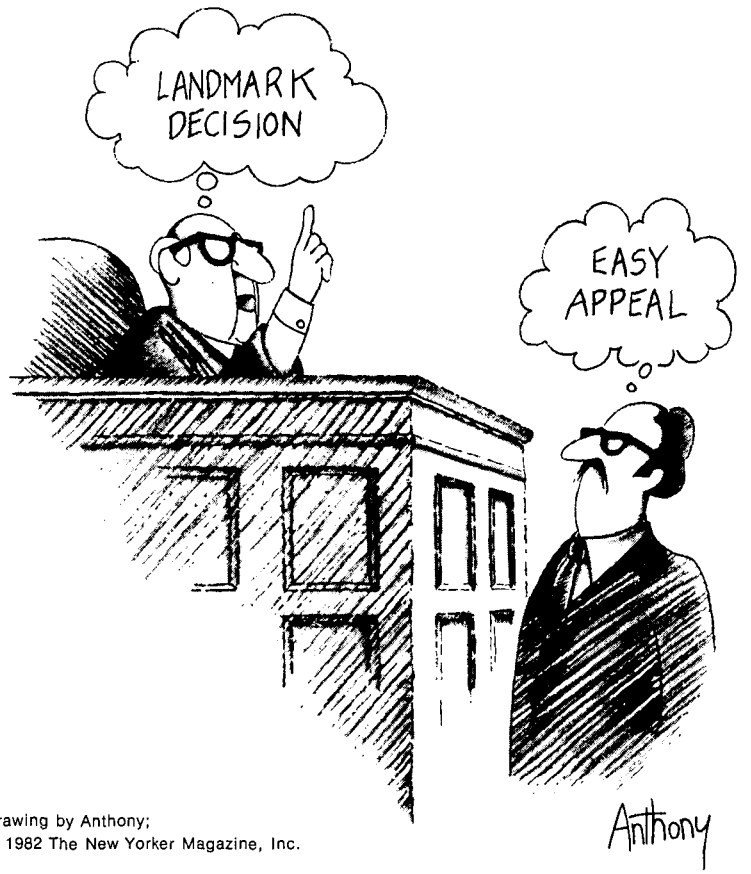
gested, because it is all bound up with the notion of Congress's "almost" legislation—so that the court speaks at times as if it is not the more general objective of automotive safety but the specific program of passive restraints that Congress itself has prescribed. That is why the last two sentences of the opinion make so little sense: "If NHTSA finds nonarbitrary reasons for rescinding the standard, of course, its action will be affirmed. Absent such reasons, or intervening action by Congress, NHTSA may not arbitrarily veer from the course the Congress has set." One would have thought that NHTSA cannot even *non*arbitrarily veer from a course that Congress has set. But of course earlier jurisprudence provides no examples of "almost" legislation.

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In the world of action, as opposed to ideas, the air-bag opinion may be inconsequential. Courts are superb obstacles, but most ineffective spurs—a quality that may have something to do with the fact that they were never intended to be the executive branch. In the present case, the court could hardly mandate the continuation of the current passive restraint rule, given the fact that there was no evidence it would be effective. Instead, it gave the agency thirty days "in which to submit a schedule for resolving the questions raised in this opinion, leading either to the rescission or suspension of the standard or to a judicially approved schedule for the effective implementation of that standard or an amended standard." In other words, the court did not mandate anything but the spinning of more wheels.

Really nice questions, adumbrated in the present opinion, lie ahead: When the agency rejects nondetachable passive-restraint seat belts on the ground that the intrusion on personal freedom (in the most literal sense) is too high a cost to pay, can that justification be sustained? When it rejects air bags on the ground that even at the lowest estimated cost—and even if that cost will be more than recovered over the vehicle's life in lower insurance premiums—the government has no business requiring such substantial mandatory expenditures for a product that could be made available (at a higher price) voluntarily, will that justification be sustained? Or what if the agency simply says: "We regard our proper governmental function to be to make sure that no defective or ill-designed features of cars *cause* accidents, and to make sure that all self-protective features are available on the open market; all the rest is nannyism"? There is language in the opinion which suggests that none of these justifications will satisfy the D.C. circuit—but that language ultimately hinges on a ghostly legislative intent that the Supreme Court may not believe in. The D.C. circuit's last major attempt to mandate a regulatory program, which involved Federal Communications Commission supervision of radio format content, came to a bad end (see "Reversing the D.C. Circuit at the FCC," Perspectives, *Regulation*, May/June 1981); this one is likely to be buried alongside it.



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# Viewpoint

**Kenneth L. Adelman**

# Biting the Hand That Cures Them

"THE INFANT FORMULA BATTLE was impressive and something of an international thriller. But it was a cakewalk compared to what lies ahead in the field of pharmaceutical policies," so wrote Stanley J. Match, president of the American Public Health Association. And indeed, in May 1981, one week after the World Health Organization (WHO) had approved the infant formula code by 118 votes to 1 (the United States being the lone dissenter), consumer union representatives of twenty-seven countries gathered in Geneva to launch a drive for international regulation of the pharmaceutical industry.

Thus, it appears that the infant formula drive was just the opening skirmish in a much larger campaign. The stunning defeat it dealt to Western interests, health groups, and corporate enterprises opposing international regulation should have stirred them to muster their forces for the campaign yet ahead. And this larger campaign could reach beyond regulation of pharmaceuticals to encompass United Nations codes on hazardous chemicals, transborder data flow, and an array of so-called consumer protection activities. Victory in one realm raises expectations for victory in another.

### United Nations Involvement

The drive for international regulation of infant formula and pharmaceuticals surely would exist in a world without the United Nations (UN). But it would not have an institutional, concrete locale. And it is the UN's organization and resources that give substance to what might otherwise be merely an abstract wish.

The mantle of legitimacy for such a drive is fashioned from the New International Economic Order, proclaimed in the 1972 United Nations General Assembly resolution that commits the United Nations to reordering the world's economic institutions. Added legitimacy is lent by Article 21 of the WHO Constitution, which gives the World Health Assembly,

**[T]his larger campaign could reach beyond . . . pharmaceuticals to encompass UN codes on hazardous chemicals, transborder data flow, and an array of so-called consumer protection activities.**

WHO's supreme body, "authority to adopt regulations concerning . . . the advertising and labeling of . . . pharmaceuticals and similar products moving in international commerce." Despite quiet mention by WHO's director-general that such regulations are unlikely in the near future, an item in WHO's 1982–83 budget providing funds for developing a proposal on the subject is a hint, perhaps, of things to come.

Besides providing the arena in which these efforts can be pursued, the United Nations also furnishes some concrete assistance. Nongovernmental organizations dedicated to international pharmaceutical restrictions receive financial, secretarial, and moral support from the United Nations' Non-Governmental Liaison Service (NGLS), which coordinates UN activities with outside groups. For example, the New York office of NGLS has hosted a "strategy session" of leading activists in the drug regulation drive. One of its program officers, Michael McCoy, sees the battle to "break the monopolies" of the pharmaceutical companies as one that "will make the breastfeeding issue look like a pebble in the pond. It's going to be a bigger

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fight, a harder fight, a nastier fight." But a fight over what?

**Drug Dumping**

The most emotional issue concerns dumping—the charge that drugs banned from use in the affluent first world are dumped on deprived third world peoples. As Indian Prime Minister Indira Gandhi told the 34th World Health Assembly in May 1981, "dangerous new drugs [have been] tried out on populations of weaker countries although their use is prohibited within the countries of manufacture."

Mrs. Gandhi, it turned out, did not know the surface facts of the matter, much less the underlying reality. When asked at a later press conference for examples of such "dangerous new drugs," she was unable to give even one. Had she been better briefed, she might have named Upjohn Company's Depo-Provera, a synthetic hormone that is injected intramuscularly in women to prevent fertility for three months. The Food and Drug Administration (FDA) banned Depo-Provera from the U.S. market in 1978 "due to controversy concerning its carcinogenic potential." But exports continued, and before long a dramatic film aired on public television showed scenes of poor black mothers in the third world being injected with a substance that is presumably too dangerous for American women.

There is a side of the story the documentary did not tell. Before the FDA's action, the agency's Advisory Committee on Obstetrics and Gynecology had recommended approval of Depo-Provera. WHO itself had endorsed its widespread use, as has the Medical Board of the International Planned Parenthood Federation. Even the American Public Health Association's joint policy committee recommended against a resolution banning its use. None of this is terribly surprising, since Depo-Provera has been widely used for a considerable period of time with few adverse effects reported. It is legal in approximately ninety countries, with about half its overall sales occurring in developed countries and half in the third world.

As this case demonstrates, U.S. companies do sell drugs in developing countries that are banned in the United States. They also sell U.S.-banned drugs in the developed countries. And they sell drugs in the United States that are banned in some parts of the third world. Again, this should not come as a surprise. The fact is that national drug approvals differ markedly—in stringency, in speed, in approaches to a particular health condition or product. Some pharmaceuticals sail through the approval process in Britain or France but flounder in the United States, and vice versa. Untidy, most certainly (as the president of G.D. Searle would put it), but that is life in the real world. And in this world, health conditions and therefore health needs vary greatly from country to country, and scientific experts often disagree. If the United States cannot agree with other developed countries on what drugs to ban, it should not shock the world, nor trouble the conscience, that it cannot agree with Sri Lanka or Paraguay.

**Dumping on Transnational Corporations**

The drive for international pharmaceutical regulation is also an attack on the larger enemy, the transnational corporation. Rabina Khan of Pakistan, who works for the UN's director-general of development and international economic cooperation, calls pharmaceutical companies "transnationals at their worst" because of their alleged rapacious irresponsibility. Opponents of transnational firms, like opponents of colonialism, tend toward devil theories, and their devil is the profit motive.

In fact, the less-developed world has not been a very attractive source of profits for business, either in colonial times or now. As British scholar J. D. Fage points out in his superb *History of Africa* (1979), private entrepreneurs —always shrewder in money matters than governments—cut their losses during the colonial era mostly by staying away. At the height of colonialism, 80 percent of British and French and 90 percent of German foreign investments headed for the developed heartlands, rather than the colonial outposts. "Africa," Fage concludes, "was of little real importance to European traders and investors."

Similarly today, according to the Commerce Department's latest study on the subject (*U.S. Direct Investment Abroad*, 1977), American pharmaceutical companies put approximately 75 percent of their foreign drug-manufacturing investment into other developed countries. And what is left—the 25 percent in-



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vestment in the developing world—yields only 14 percent of their income from total foreign investments. Moreover, drug manufacturing affiliates of U.S. companies in developing countries earned only a 3 percent return on their assets compared with 8 percent worldwide.

But preoccupation with accounting figures deflects attention from the many benefits that transnational corporations—perhaps the large drug firms most of all—have brought to the third world. Pfizer and Sterling Drug, for example, have been involved in major campaigns to control schistosomiasis in Brazil; and Ciba-Geigy, Ltd., established a large pharmaceutical research center in India explicitly to work on the diseases of developing countries. Efforts like these have produced vaccines and drugs for diseases that pose serious health risks only in the third world. More generally, the plain fact is that, especially in poor countries where other forms of health care are in short supply, drugs are the most cost-effective therapy for curing illness and prolonging life.

**Dumping on Capitalism**

The attack on multinationals, in turn, is for many merely part of a still larger attack on the capitalist economies of the West. A portion of the impetus, the energy, the will of the infant formula and pharmaceutical drives is clearly traceable to this source. Last November, for example, the Moscow Medical Workers' Union paid round-trip airfare to Moscow as well as hotel bills for representatives of 200 trade unions and organizations from fifty-seven countries. They met to organize labor against multinational drug companies, and specifically to push WHO into adopting a code of conduct to regulate the companies' marketing practices. Needless to say, the conferees blasted the West in general and praised the Soviet Union.

The anti-capitalist element of the movement is nowhere more apparent than in the accompanying campaign against drug patents. Again, the third world spokesperson is Prime Minister Gandhi, speaking to the World Health Assembly of her vision: a world "in which medical discoveries would be free of patents and there would be no profiteering from life or death." The idea, by no means a new one, has been percolating for some time in the United Nations and other third world–dominated arenas. For example, a 1980 report issued by the United Nations Industrial Development Organization (*Global Study of the Pharmaceutical Industry*) told how the "industrial property system—patents and trademarks—is one of the main constituents of a strategy of domination used by the industrialized countries to deter [sic] the scarce resources of the developing world." Developing nations, said the report, "believe that the patent legislation is a unilateral contrivance which provides full protection to the holder [as well as] a means to exploit the developing countries with no consideration to the public interest."

The point is so blatant, so glaringly misguided, that it needs no elaborate rebuttal—except to those who do not appreciate the wealth-creating effect in a capitalist system of the institution of property in general and proprietary rights in particular. In today's hocus-pocus multinational world where "rights" are created at an astounding rate, it is worth recalling that the prime document for real democracy in the world, the original U.S. Constitution, authorized the new government it established to create only one explicit right (Article I, Section 8): "To promote the progress of science by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries."

**The New Colonialism**

Perhaps most ironic in the campaign against infant formula and pharmaceuticals—no matter how tinged with anticolonialism such campaigns evidently are—is its new colonial attitude. Like the old colonialism, this new one presumes that indigenous peoples—now states—are incapable of governing themselves. They are, quite simply, not able to place their own restrictions on what they themselves consider harmful products or practices. Only developed, sophisticated peoples and international institu-

**Like the old colonialism, this new one presumes that indigenous peoples—now states—are incapable of governing themselves.**

*(Continues on page 35)*



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# The UN System's War on the Drug Industry

Harry Schwartz

THERE IS A CERTAIN IRONY in the fact that the Western pharmaceutical industry is under increasingly virulent attack from the United Nations system and the third world countries that dominate it. After all, the industry's products have been the source of virtually all important advances in medical therapy in modern times, and the peoples of the third world have been among the major beneficiaries.

Thus, as a recent *Scientific American* article has pointed out, the gain in average life expectancy in the developing countries in the fifteen years from 1950 to 1965 equaled the whole gain achieved in Western Europe in the seventy years from 1800 to 1870. The new drugs and insecticides introduced into the developing countries soon after World War II, according to the authors (Davidson Gwatkin and Sarah Brandel of the Overseas Development Council), "made it possible to control many communicable diseases and appear to be responsible for roughly half of the increase in life expectancy in the Third World." And a more subjective—and more forceful—statement on the same theme comes from Ghana's Jerry Rawlings, who explained in a radio speech that he had ousted the previous regime because it was corrupt and particularly because profiteering and hoarding of pharmaceuticals had turned Ghana's hospitals into "graveyards."

Surely the would-be regulators at the United Nations (UN) do not want hospitals in the developing countries turned into graveyards. Yet, in the past decade, an unwary observer could easily be forgiven if he gained the impression that the United Nations in general and the developing countries in particular would like to do away with the Western pharmaceutical industry entirely. A few years ago, for example, the director-general of the World Health Organization (WHO), Dr. Halfdan Mahler, accused the multinational drug companies of carrying on "drug colonialism" in the third world, and called their activities indecent. A December 1981 report from UNCTAD (the UN Conference on Trade and Development) praised Cuba as a model for developing countries, citing the fact that "all drug production has been in the public sector since 1961, and private prescription and distribution of drugs were abolished in 1960." And a well-known 1975 UNCTAD report on the transfer of pharmaceutical technology to developing coun-

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tries (by Sanjaya Lall, who has since repudiated some of its key ideas) even argued against pharmaceutical innovation on the grounds that it produced dangerous monopoly power in the industry.

At one and the same time, there have been complaints that the pharmaceutical companies greatly overcharge their third world customers, as well as complaints that the companies use African nations (to quote the Zimbabwe minister of health's remarks to an April 1982 WHO meeting) as "dumping grounds for cheap preparations which will throttle our nascent pharmaceutical industry." Both claims have some validity. That is to say, pharmaceutical prices in the third world are higher than in most Western countries (thought not much higher than in, say, New Zealand), chiefly because of transportation and other distribution costs; but those prices are lower than they would be if the developing countries were doing the manufacturing themselves. (Indian streptomycin prices have been as much as ten times world streptomycin prices.) Even so, when the pharmaceutical companies are attacked for having prices that are simultaneously too high and too low, it is hard to escape the conclusion that they are really being attacked for existing at all.

But the attacks continue, for all that, and various UN agencies have come up with some suggested responses. They are three in number: (1) the creation of "essential drug" lists, patterned after WHO's model list but adapted to specific local needs, (2) the effective abolition of drug patents in developing countries, and perhaps worldwide, and (3) the imposition of an international marketing code for pharmaceuticals. All three schemes seem to have, as an underlying assumption, the view that pharmaceutical development has already gone about as far as it can or should go.

## The Essential Drug List

For most of the past decade, the World Health Organization and other UN bodies have been pushing the idea that poor nations should buy only "essential" drugs and the associated idea that the essential drugs should be bought in the cheapest generic form instead of from research-oriented manufacturers. The objective is to eliminate needless duplication, to facilitate bulk purchasing of lowest cost drugs, and to provide guidelines for the manufacturing decisions of the national pharmaceutical enterprises many countries are creating or hope to create. Supporters of the idea argue that pharmaceuticals often account for 35 to 40 percent of some poor nation's annual health expenditures and that drug prices must therefore be exorbitant. What is ignored here is that many countries allocate only a minuscule portion of their GNP to health, and that drugs represent such a large part of that because so little is spent on doctors, nurses, and hospitals. It makes sense for developing countries to focus on medicines because they are by far the most cost-effective means of preventing, curing, or palliating diseases. (Look at the results, for example, with smallpox and polio.) It does not make much sense, however, for these countries to complain about the percentage of their health funds that they spend on medicines.

Nor does the essential-drug-list approach make much sense for all parts of the third world. For the desperately poor countries—those with annual per capita incomes under, say, $200—the essential drug list may admittedly be the counsel of despair. But many third world countries — Venezuela, Saudi Arabia, South Korea, Singapore, for example—are far from such abject poverty. In such countries as these (and there are a few dozen of them), there is a strong case to be made against primary dependence, let alone exclusive dependence, on any limited list. If, for every disease, there were one and only one drug that would cure, prevent, or palliate the disease, for each and every person suffering from it—and if such drugs had been discovered for all diseases —then one would not have to go beyond the essential list of such drugs. But, in fact, a particular drug may help, say, nine out of ten victims of a disease, while a different drug (or a combination of different drugs) may be required to help the tenth. Moreover, any limited drug list would necessarily exclude medicines needed for infrequent or very rare diseases. The more varied the medicines available to a nation's patients, the greater the percentage of patients who can be helped.

The idea of an essential drug list is often linked, as we have noted, to the idea that generic drugs are preferable (because cheaper) to pharmaceuticals carrying brand names and



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trademarks. But some developing countries have learned to their sorrow that this is not true: the lower cost of generic drugs may be more than offset by poor quality and late delivery. In 1977, a major UNCTAD publication (by S. Bibile) hailed the great savings supposedly made by Sri Lanka when that country established a monopoly drug import agency and began buying generic drugs from "non-traditional sources," including the Soviet bloc. Only later did it become public knowledge that the agency had grossly exaggerated its savings and failed to mention the losses suffered because of the poor quality of some of its generic drugs. The monopoly was ended after Sri Lanka's socialist government was defeated at the polls in 1977.

Nevertheless, the drive to convince developing nations to focus on essential drugs continues, as though the mere fact of restricting the drug formulary would work magic. Along with this drive goes the neglect of related—and very pressing—issues, particularly the need for a system of distributing medicines, for ensuring that drugs are discarded when they have lost their potency, and for seeing to it that drugs requiring special handling (refrigeration, for example) receive it. In many developing nations, medicines are plentiful only in the capital city, which often has a major hospital with Western-trained specialists and expensive Western equipment for the most modern diagnostic and surgical procedures. Yet, in rural areas a dozen miles away, there are few drugs and fewer doctors, and the pharmaceutical famine grows more acute as the distance from the capital lengthens.

To get drugs and doctors to the people of the developing countries has become a matter of increasing concern to the pharmaceutical manufacturers. In early 1980 the International Federation of Pharmaceutical Manufacturers' Associations (IFPMA) told the World Health Organization that some members of IFPMA were willing to negotiate low concessionary prices for sales to the most poverty-stricken countries. In January 1982 (after two years of bureaucratic delay) WHO suddenly announced that the IFPMA offer was being received with great satisfaction, and the May 1982 meeting of the World Health Assembly reacted with similar favor. Forty-six of IFPMA's member companies have now agreed to sell some 230 drugs and vaccines (of which 135 are on the model WHO list of essential drugs) to some of the poorest developing countries at prices the IFPMA executive vice-president has called "favorable." The exact figures are to depend on quantity, pack sizes, dates of delivery, and the like.

In addition, some Western pharmaceutical firms have begun to train citizens of some of the least-developed countries to solve problems of drug logistics and distribution—a step whose proliferation throughout the world is likely to prove more valuable in the long run than the IFPMA initiative (even though that initiative seems more in line with UN desires). Among pilot projects now under way are those sponsored by U.S. firms in Gambia and Swiss firms in Burundi.

Both the essential-drug-list approach and the attempts to build infrastructure have in common the assumption that the important thing is delivering the drugs we have rather than developing new drugs. But the latter is important too, and that is where the real trouble begins.

## The War against Trademarks and Patents

Brand names and trademarks establish a manufacturer's responsibility for its products and assure customers of quality—an assurance for which the customers are willing to pay a premium. To the foes of transnational pharmaceutical companies, however, trademarks are simply a device for giving firms intolerable market power. Typical of what some parts of the UN bureaucracy would like to achieve are the recommendations of an August 1981 draft report of the World Intellectual Property Organization. Arguing that trademarks on pharmaceuticals may be redundant and may increase prices, the report urged that serious consideration be given to limiting or prohibiting the use of such trademarks, especially in developing countries. (Given that even the political parties in such countries must use trademarks on the ballot for the benefit of a largely illiterate mass of voters, one wonders what the trademarks on pharmaceuticals will be replaced with.)

This drive against trademarks is supported by such influential third world countries as India, Yugoslavia, and Mexico, which have



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significantly limited the use of international trademarks in their own national markets. In fact, the World Intellectual Property Organization, established within the UN as the successor to previous international bodies created to defend the rights of those who own intellectual property, has increasingly become a forum for third world calls to confiscate intellectual property. The tendency to use it in this way is strengthened by the fact that many third world leaders have their eyes firmly fixed on the advantages to them of creating domestic pharmaceutical industries, while the Western nations are represented by diplomats generally keeping at least one eye on their standing with the third world. In addition, some Western countries (France, for example, whose minister of health is a Communist, or Sweden, or Holland) agree with the third world on ideological grounds.

The war against trademarks is only half the story—and the less important half. With it we are still in the realm of already existing drugs. It is the war against patent protection that takes us into the area of greatest danger.

The basis of existing international patent protection is the Paris Convention of 1883, whose provisions have fostered technical innovation and the prompt spread of innovation throughout the world for a century. But in October 1981, the Nairobi Diplomatic Conference for revision of the Paris Convention tentatively approved two changes relating to actions a developing country can take in the event of "failure to work" a patent. Only the United States expressed active opposition. One change would allow a developing country to give an exclusive compulsory license for the use of a particular patent to anyone it wishes if, two-and-a-half years after the patent has been granted, the granting country determines that it has not been worked adequately. An even more drastic change would give developing countries the right to revoke a patent five years after granting it, if the compulsory license granted earlier has not brought about what the country involved regards as adequate working of a patent.

While these changes would apply to all patents, their impact on the innovative pharmaceutical industry would be particularly crippling. First, working a drug patent means manufacturing the drug, all the way from initial raw materials to the final formulation ready for sale and consumption. It must be emphasized that, even if a pharmaceutical company has a multimillion dollar plant in a developing country, one that is manufacturing different dosage forms of a drug from imported intermediate chemicals, this would not be considered "working a patent" in that country. Even under the milder of the two provisions, a firm that discovered a new medicine and was manufacturing dosage forms of that medicine in a given country for distribution in that country could find the exclusive right to manufacture the drug assigned to someone else, making it illegal for the company to continue manufacturing its own drug.

Second, the effect of these two provisions would be especially great because of the character of the drug approval process. Application for a patent on a new drug is made as soon as possible after discovery, and the patent is (mostly) granted in due course. But the drug itself cannot be marketed until it has been cleared by the appropriate national body—the Food and Drug Administration (FDA) in the United States, for example. The process of winning approval for marketing can and often does take even longer than five years, certainly in the United States where the FDA's slowness in granting approvals has created the much publicized U.S. "drug lag." Thus the Nairobi proposals would seriously threaten the pharmaceutical companies with loss of their patent rights because they have not yet begun the manufacture of an unapproved drug.

One reason the Nairobi proposals got almost automatic approval from most countries represented there is that in most other industries there is no need for the pre-marketing approval process required for pharmaceuticals—or, at least, that is my conjecture. It is also worth noting that Canada, Australia, New Zealand, Spain, Portugal, and Turkey—three of them clearly first world countries and the other three borderline—declared at Nairobi that, in relation to pharmaceuticals, they regard themselves as developing countries entitled to these special developing-country rights. (Countries like these, incidentally, which do not suffer from the third world diseases for which adequate medicines are still to be developed, would benefit much more than the third world from a successful attack on pharmaceutical patents.)



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Why should weakening patents for new medicines disturb the general world community? An eloquent answer emerges from a recent book *attacking* the multinational pharmaceutical industry. Milton Silverman, Philip Lee, and Mia Lydecker, in their *Prescriptions for Death*, give this unequivocal judgment for patent protection:

> It seems to us that wiping out patent protection for new drugs would be a short-term boon for some countries but a long-term disaster for the world. It would effectively choke off much if not most of the industry's research and the development of better drugs. Some industry critics have countered that much of the industry's research is wasteful and needless, and that the important investigations can be taken over easily by university and government laboratories. For the last thirty or forty years, however, the record is clear that although some of these nonindustry institutions have contributed magnificently to basic research, they have turned out few important products. Certainly in difficult economic times with tight budgets, few government agencies or university research centers would be willing to take the gamble of investing the enormous resources and the many years now required in modern drug development.

The countries of the third world should be taking those words to heart.

## The International Marketing Code for Pharmaceuticals

Finally we turn to the third prong of the UN attack, a code on marketing practices to be formulated and promulgated by the World Health Organization or some other UN body. The precedent would be WHO's adoption of a stringent marketing code for infant formula. And the basic assumption would be that the drive for private profit by multinational drug companies, as the Lall report put it, "is not compatible with the well-being of the vast majority of the world's population." Those pushing for such a code know well, or should have learned from the infant formula battle, how easy it is to arouse Western public opinion to moral outrage through a well-orchestrated campaign attacking alleged industry abuses.

At this point we should perhaps step back and view the issue in some perspective. The Western pharmaceutical industry sells its products in well over 100 countries, where the levels of cultural, educational, economic, and medical development vary enormously, as do the local practices and standards of political morality. It would be unrealistic to assume that pharmaceutical marketing in the third world is unaffected by a national or local atmosphere of cynicism, or tolerance of corruption, or probably (in some cases) the virtual necessity of *baksheesh*. There have, indeed, been dismaying instances of abuses in pharmaceutical marketing in the third world.

Many of these abuses have involved the sale of medicines for whose efficacy extravagant claims have been made and about whose potential dangers too little or nothing has been said. Lack of properly controlled distribution networks in developing countries may have contributed to the problem. Another contributing factor may be that the Western pharmaceutical companies are accustomed to prescriptions written by doctors and filled by registered pharmacists, while third world countries often do without prescriptions and are interested in getting medicines to as many people as possible—a situation not ideally suited for safeguards. Both factors can produce an element of carelessness in an area where any carelessness may be too much.

But carelessness is not the only abuse. Drug sales in various countries are often made through friendship, "contacts," the giving of samples—a very personal kind of marketing network. In countries where personal gifts usually accompany business deals, the line separating bribery from custom is pretty uncertain.

That does not excuse companies clearly on the wrong side of the line. But are we to impose on the developing countries a marketing code whereby every drug (1) should be sold in every country only for the purposes approved by the FDA in this country, (2) should be accompanied by all the warnings in our *Physician's Desk Reference*, (3) and should be sold without any advertising or other marketing effort aimed at doctors and/or patients? Supporters of the code, by and large, want roughly that. But apart from imposing our own "drug lag" on the world at large (and perhaps even wind-



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ing up with requirements that a drug for a disease that does not exist in the United States would have to be tested and approved in the United States), it is hard to see what the first of these provisions would do. The second is unlikely to do much harm, but it is also unlikely to do much good. It is certainly arguable that it is not particularly important to cite (in, say, Paraguay or Uganda) a 1-in-40,000 chance of a given side-effect when the immediately important thing is curing the 40,000. Even worrying about a 1-in-100 side effect may be a luxury when one is trying to eliminate a disease attacking much of the population in a given country (as schistosomiasis). And as for arms-length marketing, we may ask whether Sri Lanka would not have been better off succumbing to pharmaceutical company blandishments and getting better-quality drugs on time.

All this having been said, it is nevertheless true that Western public opinion expects—and has a right to expect—a high standard of conduct from its major corporations. The pressure of this expectation has already brought some significant changes. Last year IFPMA adopted a voluntary marketing code that pledges "full candor in dealings with public health officials, health care professionals, and the public" and requires that "information on pharmaceutical products should be accurate, fair and objective, and presented in such a way as to conform not only to legal requirements but also to ethical standards and to standards of good taste." Also, in an oblique reference to charges of bribery, "scientific objectives should be the principal focus" in arranging medical symposia, and "entertainment and other hospitality shall not be inconsistent with such objectives." Early this year, in response to charges that its voluntary code lacked enforcement mechanisms, IFPMA established a committee consisting of its president, executive vice-president, and two vice-presidents to oversee the code. "The major sanction against any company that transgresses the code will continue to be the sanction of adverse publicity." (IFPMA has also noted its willingness to supply foreign governments with current issues of the *Physician's Desk Reference*, or its British, French, or West German counterparts.)

In spite of these measures, many still expected a historic confrontation over WHO's proposed code at the May 1982 meeting of the World Health Assembly in Geneva. The reality was quite different—a near consensus in favor of giving the industry's voluntary code a chance. In part this happened because Secretary of Health and Human Services Richard Schweiker addressed the meeting, making quite plain the Reagan administration's opposition to this and other needless UN meddling in the pharmaceutical field. Many of his listeners must have remembered how the United States had pulled out of the International Labor Organization for three years (1977–80) and stopped paying its very substantial dues, returning only after the ILO's policy had become more sensible. There were few in Geneva who wanted WHO to be a second victim of such American wrath. Only the hardliners—notably Cuba and Romania, scarcely nonaligned third world countries—spoke out directly in favor of UN-imposed regulation of world pharmaceutical marketing.

Clearly, the IFPMA marketing code and the industry's offer to sell some drugs at concessionary prices have brought about a temporary truce. This development was underscored at IFPMA's biennial convention in Washington, D.C., in June, when Director-General Mahler of WHO hailed "the new era of cooperation" and won a standing ovation from the audience of pharmaceutical executives. Neither side at the meeting ignored the points of continuing friction, but both gave much evidence of wanting to get along.

## Truce or Peace? Where Do We Go from Here?

It is difficult to predict how long this era of relative good feeling will persist. It is all too easy to imagine future developments that would again poison the atmosphere. Certainly many in the UN bureaucracy and in positions of power in the developing countries will continue to distrust the drug companies. But whatever the future holds, the present gives ground for modest hope—especially if the international patent system is not wrecked. The results should be better health in the developing countries—along with continued profits from drug innovation which in turn will help pay for further research into debilitating third world diseases.

If what we have is really peace. ■



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# The New Era in Antitrust

**Joe Sims**
**William Blumenthal**

ON THE SAME DAY in mid-June that the Justice Department released the long-awaited revision of its 1968 Merger Guidelines, the Federal Trade Commission released a separate "statement" setting forth its policy on horizontal mergers. Neither document changes existing enforcement policy very much. Both, however, are reminders of the substantial shifts that have occurred over the last decade in the government's approach to merger analysis. And the differences between the two documents highlight the differences between the two enforcement agencies.

## The Triumph of Economics

As the Justice Department's new guidelines make clear, the analytical process by which the department evaluates mergers has become explicitly economic. The 1968 guidelines nodded generally toward economic analysis; the new guidelines incorporate numerous tests based upon elasticities, a concept that only economists could love. More important than the changed process, however, is that the substantive standards governing the enforcement decision have been eased, in some instances radically. Vertical and conglomerate mergers have been virtually immunized against challenge. Horizontal mergers will be treated more leniently than under the 1968 guidelines in unconcentrated markets, but only slightly more leniently in concentrated markets.

The Federal Trade Commission has moved in the same direction as the Justice Department, but not quite so far. While the commission's analytical process has become explicitly economic, it has not become exclusively so. Leeway for other values may remain. And some have interpreted the commission's new policy, limited by its terms to horizontal mergers, as not retrenching so substantially as the Justice Department's in the area of vertical and conglomerate mergers.

**. . . economic considerations have now achieved primacy over social and political considerations as the basis for merger policy. . . .**

Before examining these policy shifts in greater detail, it is useful to understand the two principal reasons they have taken place. First, economic considerations have now achieved primacy over social and political considerations as the basis for merger policy, whereas these three considerations used to receive more

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or less equal billing. The Supreme Court, for example, wrote in *Brown Shoe* (1962):

> The "dominant theme pervading congressional consideration of the [antimerger provisions of the antitrust laws] was a fear of what was considered to be a rising tide of economic concentration in the American economy. . . . Other considerations cited in support of the bill," the desirability of retaining "local control" over industry and the protection of small businesses.

The Court also quoted from Judge Learned Hand's famous *Alcoa* opinion:

> Throughout the history of these [antitrust] statutes it has been constantly assumed that one of their purposes was to perpetuate and preserve, for its own sake and in spite of possible cost, an organization of industry in small units which can effectively compete with each other.

Such populist sentiments have been deeply eroded over the last decade, as leading scholars have with increasing frequency denied the legitimacy of antitrust's social and political goals. Taking issue with Judge Hand, Robert Bork declared: "The only legitimate goal of American antitrust law is the maximization of consumer welfare." The thought was echoed by Richard Posner and William Baxter. Still others, somewhat more traditionally, contended that social and political considerations are, if not vapid and irrelevant, at least vague and unquantifiable. Economics provided decision makers with an accessible intellectual calculus leading to relatively clear results. Sociology and political science, in contrast, provided only garbled generalities with no clear policy indication.

The second reason that merger policy has shifted over the last decade is that our understanding of economics has changed. To put the issue in context, once one accepts that the goal of antitrust law is to maximize consumer welfare, the policy prescriptions for achieving that goal may vary widely, depending on the current state of economic thinking. As economic research yields new findings, merger policy should change accordingly. Advances in economic understanding on two fronts have contributed most heavily to the recent revisions in merger policy. First, it is now recognized that the relationship between concentration and noncompetitive performance is not so well defined as had been previously supposed. Some economists, such as Harold Demsetz, have argued that no relationship at all has been shown, and most economists would agree that the 1968 guidelines were too stringent and failed to take proper account of the fact that numerous economic characteristics other than concentration influence a market's competitive state. Second, it is now recognized that mergers may yield efficiencies for many more reasons and to a far greater degree than had been previously supposed. Under the older view, the principal efficiencies realized through merger were attributable to economies of scale. The newer view goes further and recognizes additional efficiencies attributable to reduction in the cost of information and creation of intra-firm "markets" for capital, labor, and other resources (see Readings, page 51).

### Vertical and Conglomerate Mergers

Having touched upon the reasons for the policy shifts in the guidelines, we can now return to examine the shifts in greater depth. The Justice Department's merger policy has been revised most markedly in the area of vertical and conglomerate mergers. The 1968 guidelines presented explicit (and fairly intolerant) prohibitions against vertical and conglomerate mergers. A vertical merger between one firm having a 10 percent share in one market and another having a 6 percent share in an adjacent supplier or purchaser market might have provoked a challenge, for fear that it would foreclose access to one market by the remaining firms in the other. And a conglomerate merger might have been challenged whenever it eliminated a potential competitor, created the danger that each would deal with the other to the exclusion of third parties, or entrenched the market power of a leading firm. In practice, these provisions of the 1968 guidelines only occasionally led to enforcement actions, but they captured the attitudes of the era.

Those attitudes have changed. The new guidelines merely caution that "nonhorizontal" mergers will be challenged only where they have substantial anticompetitive horizontal effects. The guidelines tell us that the proscribed effect may, in theory, be anticipated in four instances—if the merger eliminates a potential competitor, creates barriers to entry, facili-



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tates collusion because of vertical integration (likely only in some limited circumstances), or enhances the ability to evade rate regulation. One gets the definite sense, however, that the necessary and sufficient prerequisites to a challenge will rarely be found.

Why the radical change? First, the efficiencies that may be generated by vertical and conglomerate mergers are more pronounced than had been realized in 1968, largely because those efficiencies are of the "information cost" and "internal markets" varieties which had not been well identified when the old guidelines were written. Second, the costs of vertical and conglomerate mergers fall largely into the social and political realm and are therefore disregarded in the new guidelines. (The "unifying theme" of these guidelines, we are told at the outset, "is that mergers should not be permitted to create or enhance 'market power' or to facilitate its exercise," where market power is defined as the ability to maintain price profitably above competitive levels. This is strictly an economic concept.) Insofar as vertical or conglomerate mergers impose economic costs, they may be attacked under the guidelines.

The policy of the Federal Trade Commission (FTC) is less clear to the outside observer, because the commission's mid-June policy statement was limited by its terms to horizontal mergers. Some have read this to signal that the commission is abandoning enforcement against vertical and conglomerate mergers, but it seems more likely that some of the members of the commission would sharply disagree with the Justice Department's approach. While the commission has predominantly and increasingly focused upon economic values, it has not followed the Justice Department in discarding the last vestiges of social and political values. If a vertical or conglomerate merger were to impose severe social or political costs with few offsetting economic efficiencies, the commission might still bring an enforcement action. Nonetheless, its position has softened over the last decade (although perhaps not so much as the Justice Department's). Where it once would have sprung to action, it is now likely to proceed slowly and cautiously.

**While the FTC has predominantly and increasingly focused upon economic values, it has not followed the Justice Department in discarding the last vestiges of social and political values.**

### Horizontal Mergers

The FTC and the Justice Department differ slightly as to horizontal mergers as well, but here the difference seems more procedural than substantive. Both the department's new guidelines and the commission's statement view horizontal mergers as posing a clear threat to consumer welfare and thus something that must still be scrutinized closely. The enforcement standards have, however, been modified (quite explicitly in the guidelines and more implicitly in the statement) to take account of the current understanding of the relationship between concentration and market performance. In unconcentrated markets, virtually any merger is likely to pass muster, whereas the 1968 guidelines would have prohibited a merger between two parties controlling as little as 5 percent of the market apiece. In moderately and highly concentrated markets, however, the market share standards have been relaxed only slightly from the 1968 levels. In addition, the new guidelines take explicit notice of a long list of additional market characteristics that may color the government's judgment, including product homogeneity, transaction size and frequency, and pricing structure. The importance of such characteristics is now recognized as being greater than previously thought.

The chief difference between the agencies is how to weigh these numerous decision factors against one another. The Justice Department's guidelines establish strong presumptions based on concentration levels and the parties' market shares; other factors are to be taken into account only in close or exceptional cases. The Federal Trade Commission's statement, in contrast, suggests that all factors are to be considered in every instance, with none providing a presumptive basis for an enforcement decision. The commission has traditionally been amenable to a broader line of argument than the Justice Department, and its horizontal merger statement suggests that it continues to be.



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The agencies also differ substantially over the treatment of efficiencies. The Justice Department is unreceptive to the argument than an otherwise unlawful merger should be permitted because it will yield sizable economic efficiencies. In the department's view, the guidelines' market-share thresholds were set high enough to allow the realization of available efficiencies "in the overwhelming majority of cases." The efficiency defense is considered so difficult to administer—as the department notes, "efficiencies are far easier to allege than to prove"—that enforcement resources should not be wasted solely for fear that the guideline thresholds might prove too low in a few isolated instances. Besides, most efficiencies can be realized through internal growth just as easily as through merger.

At the antipodal extreme stands FTC Chairman James Miller, who believes that "scale-type efficiencies should be considered as part of the legal analysis" of proposed horizontal mergers. The commission itself takes something of an intermediate position: efficiency arguments are appropriate for the agency to consider in exercising its prosecutorial discretion, but are too ambiguous to be treated as a legally cognizable defense. This is distinctly more receptive than the Justice Department's view, but it does raise very interesting questions about the proper standards for agency decision making. Is it appropriate for an agency to invite arguments to be weighed in the exercise of its prosecutorial discretion to initiate an administrative proceeding, but then refuse to listen to those same arguments in the context of adjudicating that same proceeding? There is no doubt the commission (and probably the courts) will have a chance to answer that question fairly soon.

Finally, the agencies appear to differ over the extent to which economic tests can replace discretion as the basis for enforcement decisions. The commission's statement, while recognizing economics as the chief basis for antitrust policy and identifying economic factors for the decision maker to weigh, leaves the weighing process to human judgment. The department, in contrast, would replace subjective judgment with economic tests to the extent possible. In defining the relevant product market, for example, the guidelines call on the department initially to define a provisional product market based on the output of the merging firms and then to probe the boundaries of the market based on an elasticity measurement:

> the Department will hypothesize a price increase of five percent and ask how many buyers would be likely to shift to the other products within one year. The Department will continue expanding the provisional market until it satisfies the general profitability standard. . . .

That standard defines a market as "a group of products such that a hypothetical firm that was the only present and future seller of those products could raise price profitably."

The same approach appears repeatedly throughout the guidelines. In defining the relevant geographic market, the department must identify a provisional market area on the basis of the merger parties' shipment patterns and then determine whether the area is sufficiently insulated from outside competitive pressures that a 5 percent increase in the price of the relevant product could be sustained after one year. Similarly, the guidelines measure "production substitution" in terms of the number of firms that would convert existing facilities to production of the relevant product within six months of a 5 percent price increase, a shorter period than is used for market definition. And the guidelines measure the height of entry barriers in terms of the number of new entrants within two years of a 5 percent price increase, a period that some economists have criticized as overly generous.

THE JUSTICE DEPARTMENT'S NEW POLICY and to a lesser extent the FTC's imply a scientific approach that will surely not be possible in the great majority of situations. Even the department seems to recognize as much, for its guidelines identify numerous subjective factors to which it "will give particular weight" and on which it "often will have to rely [for] inferences." Nonetheless, the guidelines not only suggest that the department believes its policy is now crowned with the halo of science but are abundantly clear on which science has been chosen. These documents are an important step toward a more predictable pattern of public antitrust enforcement. If they survive the test of time, the next target will be private damage actions—currently the one totally uncontrollable element of antitrust enforcement. ■



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# Electric Utilities—Next Stop for Deregulators?

**Irwin M. Stelzer**

THE DEREGULATORS are homing in on a new target: the electric utility industry. Indeed, they have already enlisted the interest of the Federal Energy Regulatory Commission or FERC (which is seeking industry volunteers for "experiments" in deregulation), the Department of Energy (which is busy dishing out contracts to students of the problem), the academic community (which is looking for new industries to conquer) and, most significant, at least one major electric utility (Virginia Electric & Power Company).

This interest in deregulating the industry has three sources. First, airline deregulation has been fabulously successful, the complaints of the re-cartelists notwithstanding. It has resulted in lower and more varied fares, entry by small innovative newcomers, improved service even for small communities, more efficient utilization of capacity, and a declining number of passenger complaints. (See David Graham and Daniel Kaplan, "Airline Deregulation *Is* Working," *Regulation*, May/June 1982, page 26.) This success spurred efforts to ease regulatory controls over railroad rates, interstate trucking, and telecommunications. Despite some recent backsliding by the supposedly pro-competitive Reagan administration, the political climate seems to favor deregulation, viewed by the public as part of a program to "get the government off the backs of the people."

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Second, increasing doubt has arisen about the validity of the basis for regulating electric utilities. Is this industry, in other words, still characterized (if it ever was) by such substantial economies of scale and coordination that competition is infeasible and vertical integration essential? The notion that small is not only beautiful, but efficient, is now more widely (wildly?) held than ever, giving credence to the view that competition can replace regulation as the public's protector against exploitation.

Third, and in my view most important, a feeling has developed that regulation of the electric utility business is not working. Some utilities continue to burn oil when a shift to coal would be in the nation's and the customers' interests; and some cannot get permits to build needed plants, while others have the permits but cannot afford to build the plants. The industry's critics argue that the regulators protect inefficient, slovenly managed electric companies with cost-plus regulation that provides no incentive to efficiency. The regulators, in turn, feel impotent in the face of perceived political opposition to adequate rates and would like somehow to get off the hook on which they feel impaled. And the industry itself agrees that regulation is not working—but for a different reason—because it keeps rates so low that earnings on equity are below interest rates on debt and stocks sell far below book value. It is not unfair to say that *if* utilities were earning their cost of capital, *if* stocks were



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selling at book, *if* debt coverages were adequate and debt capital salable on reasonable terms, much of the interest in deregulation would evaporate, at least on the part of the industry and its regulators.

The reasons underlying the support for deregulation tell us what the objectives, or benefits, of deregulation are thought to be. For the industry's critics, the chief goal is improved efficiency in the planning, construction, and operation of power plants and systems, along with the resulting lower rates. The industry itself, satisfied that its planning is already close to optimal, is mainly interested in higher earnings, while the regulators seek relief from responsibility. And all three parties would like to see a situation in which new entrants to the power production business, or perhaps existing utilities, could attract (otherwise unavailable) capital to the industry.

**The Deregulation Scenario**

In order to understand how these benefits are to be achieved, we must first try to understand how the scheme would work. This is not easy, as there are almost as many deregulation scenarios as there are deregulators.[1] (None of these scenarios, incidentally, includes one in which the regulators simply ride off into a CAB-type sunset, leaving managements free to exploit their monopoly power.) But it is not unfair to synthesize and summarize the various deregulation proposals as follows:

The distribution of electrical power is a natural monopoly and therefore should continue to be regulated. But the functions of generating, transmitting and distributing electricity, which are combined in today's utility companies, should be separated. Distributors should buy their power from a host of independent generating companies, at competitive prices—which power would be transmitted over the lines of independent transmission companies, perhaps operating as regulated common carriers or perhaps government-owned.

This system's attractiveness is not to be underestimated. It promises, in one fell swoop, to:

- Replace regulation with competition at the generating level, putting pressure on power producers to build the most efficient possible plants and operate them at lowest cost;
- Give distributors and their customers an opportunity to buy power from the cheapest source, either by changing sources easily or, at a minimum, by benefiting from competitive offerings of long-term contracts;
- Encourage entry into the generating business by investors who think they can make money offering power at competitive rates;
- Discourage the construction of unneeded plants, because no one would have an assured outlet for his power; and
- Eliminate the costs and delays associated with regulation.

This is, it must be conceded, a formidable set of hypothetical advantages. In order to decide whether they are likely to flow from deregulation, we have to consider how a deregulated utility system might be structured and operated. As a starting point, let us take one of the more detailed deregulation proposals—that outlined in the MIT Energy Laboratory working paper.

The industry would be structured as follows: A regional transmission company, which would be regulated or government-owned, would purchase electricity from competing, separate generating companies and would sell it to all distributors in the region. The transmission company would not contract with generating companies for long-term capacity commitments. Instead, it would purchase on a spot basis at prices that changed every five minutes. Computers would allow continuously fluctuating price signals to be communicated to generating companies. Large customers and distributors, for whom sophisticated metering is economically feasible, would pay the varying spot prices of generation plus the necessary transmission markup.

How would spot prices be determined? The transmission system would establish a single price for each five minute period. It would set that price just high enough to induce the de-

[1] For some examples, see Remarks of William W. Berry, before the 21st Annual Regulatory Conference, Iowa State University, Ames, Iowa, May 20, 1982; B. W. Golub et al., "Deregulating the Electric Utility Industry: Discussion and a Proposed Approach," MIT Energy Laboratory Working Paper, July 1981; David Hughes, "Is There Life after Deregulation?" paper at Institute for Study of Rate Design Problems of Regulated Industries, February 8, 1982; and J. D. Pace, "Deregulating Electric Generation: An Economist's Perspective," paper at International Association of Energy Economists, November 12, 1981.



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sired amount of generation—equal to the marginal running cost of the marginal generating unit at the desired level of production. All else being equal, a profit-maximizing generating company would bring its unit on line any time the spot price rose above its incremental start-up and running costs. As a result, economic behavior by individual generating companies should mimic the central dispatch of electric power from generating units contained in regional power pools.

A generating unit failure would drive up the spot price almost instantaneously, thus calling forth higher-cost, hitherto idle, generating capacity. If consumer demand threatened to exceed supply at a price high enough to call forth all available capacity, the spot price would be raised to whatever level was required to depress demand to the acceptable level. Since generating companies and large electricity users would face the same spot price (aside from the transmission and distribution mark-up), the higher prices needed to discourage demand would mean higher prices, and thus higher profits, for generating companies. This means that, if capacity generally were tight and demand frequently pressed on available supply, the generation business would become very profitable and firms would be induced to build additional generating capacity. It is this profit lure that would ensure, over time, that adequate capacity would be built. Those entrepreneurs who guessed capacity needs correctly and built cost-effective units would earn high profits; those who guessed wrong might go bankrupt. Presumably, bankruptcies would not remove capacity from the market as the units would be operated by trustees or bought by other companies.

Under this plan, distributors and large industrial customers, faced with continually varying spot prices, would curtail less essential uses as the price rose. Prices would be much simpler than they are today. There would be no fixed monthly customer charge, no demand charges or backup charges,[2] and only two customer classes. (Because of high metering and communications costs, the varying spot prices would not apply to residential or small commercial customers.)

This MIT scenario also envisions various independent middlemen and brokers who would package energy entitlements for sale to investors (as mutual funds package securities) and offer long-term contracts to customers wanting stable or predictable prices.

The unanswered questions that leap to mind are legion. I discuss five of them here.

### How Is the Present Vertical Integration to Be Undone?

All serious deregulation proposals, even those emanating from the industry, call for some vertical disintegration—that is, some separation of generation, transmission, and distribution. This would create some serious problems, particularly if the goal is to set up effectively competitive markets within each region. For if we are to have competition, not only would generation have to be separated from transmission and distribution, but in each region a utility's generating plants would have to be spun off to a sufficient number of independent, competing firms to produce effective competition. It would do little to improve efficiency if the generating plants of a utility were sold to a single, new generating entity: the new entity's monopoly power would be substantial, especially in the short run, even if constrained somewhat by free access to its markets by suppliers from other regions.

**It would do little to improve efficiency if the generating plants of a utility were sold to a single, new generating entity. . . .**

The transition task, then, would be vertical disintegration *and* deconcentration. The spun-off facilities would, most probably, have to be sold to these numerous new firms for cash and at book value, so that bondholders could be paid off as the indenture instruments provide. And the buyer would most probably have to raise the needed cash by selling equity, since (for reasons discussed later) the venture would, at least initially, be too risky for the tastes of bondholders. Keep in mind that what

[2]Demand charges are fees paid by larger customers based on their highest monthly usage and designed to cover the fixed cost of serving them; backup charges are fees for utility capacity held available should a customer's own facilities be unavailable or inadequate.



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we are talking about is a very large bundle of capital—between $100 and $150 billion.

Of course, *any* transition from regulation to competition involves difficult problems: in trucking, the writing down of values assigned to operating certificates was a knotty, multimillion dollar problem, and in airlines, the question of who "owned" routes and slots acquired in the CAB's heyday proved a difficult one to resolve. But problems of this sort are worth overcoming if their cost is exceeded by the benefits reasonably to be anticipated from the new order. Would this be the case with electric utility deregulation?

**Who Would Invest in Generating Stations?**

Perhaps the most important question is whether vertical disintegration and deregulation would open the way to investment in new generating stations (I leave aside the question of who would buy the existing plants) and, if they do, whether such radical restructuring would be the most efficient way to attract new capital. Any potential entrepreneur considering entering this capital-intensive industry would have to face three kinds of risks:

*Normal business risks.* Will markets develop? Can the plant be brought in at close to its projected cost? Will environmental rules change? Entrepreneurs in most industries face these risks; potential investors in power plants might face them to an even greater degree.

*Government competition.* The electric generating business is characterized by a large government-owned and subsidized segment: a third of the capacity now being built is owned by government bodies. So, anyone who enters a competitive generating market would be vying for business with subsidized competitors both here and abroad (Canada). This is a problem that potential entrants in most other capital-intensive industries do not have.

*A strange combination of maturity and novelty.* Any investor would have to face the fact that markets for power from large central stations are, or at least seem to be, mature. Growth in electricity usage has slowed, while competition from small power producers, which are favored by government tax benefits, is increasing. Moreover, demand elasticity is no longer insignificant (if ever it was), reducing the scope for real increases in price. Finally, the possibility of significant profit improvement through cost-saving innovation now seems small or at least highly uncertain. At the same time, the entrepreneur would be engaging in an enormous experiment. He would be attempting to sell a product (electricity) in a manner in which it had never been sold before, through a mechanism not now in existence (would it be brokers? transmission companies?), and at prices (replacement cost) never tested for market acceptance.

This recitation of ordinary and extraordinary risk should not be taken to mean that entrepreneurs could not, in any circumstances, obtain capital to build new generating stations. Rather, it means that one of two things would have to happen. Either devices would have to be developed to reduce risk (long-term take-or-pay contracts, of which more later), or risk premiums would have to be paid for the capital. The latter would take the form of increasing the portion of equity relative to debt capital. Since interest payments are deductible expenses, while equity earnings are taxable income, rate payers would find themselves paying about 20 percent more for electricity than they now do (remember that electricity is currently priced below cost). A portion of this post-deregulation increase—about half—would be simply a transfer payment to the government (taxes on equity earnings); another portion would represent the termination of the subsidy to consumers from a base rate that is uneconomically low; and the final portion would represent payment for real increases in risk.

Two conclusions seem obvious. First, consumers—who are indifferent to economists' distinctions between real and artificial cost increases—should not be expected to be as enthusiastic about deregulation of electric utilities as they have been about deregulation of, say, trucking. Second, the rate increases would probably not be big enough for us summarily to reject deregulation as either politically infeasible or economically undesirable: the savings from efficiency resulting from the pressure of competition might offset the higher cost of capital. But we should certainly attempt some rough calculations of this type to see, if only approximately, how great the efficiency improvements would have to be to offset the costs of increased risk. And if it should turn out that deregulation would result in higher rates, even



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in the short run, we must question whether the political support for it would evaporate—remember, airline deregulation was popular because rates came *down*—and whether all the restructuring would be worthwhile. After all,

**. . . if it should turn out that deregulation would result in higher rates, . . . we must question whether the political support for it would evaporate . . . and whether all the restructuring would be worthwhile.**

regulated rates, if they could be set at economic rather than politically dictated levels, would solve almost as many problems.

### How Would the Economies of Coordination Be Obtained?

Much of the discussion of deregulation draws on two separate empirical observations. First, economies of scale in individual generating *plants* appear to be such that every region of the country can (and does) support many plants of minimum efficient scale. This empirical observation has led some to conclude that many separate firms could *generate* electricity efficiently in any region.

Second, there appear to be substantial *system* economies that can only be fully exploited by coordinating the dispatch of electricity from all the plants in a region, the construction of new plants, and the planning of transmission lines. While there is sharp disagreement about the extent of these coordination economies, they probably extend at least to the regional level. Individual utilities have found it desirable to participate in state or regional power pools in order fully to exploit economies of coordination. The observation that there are substantial coordination economies at the system level has led some observers to suggest that there be more power pooling, or even more horizontal integration of those individual utilities that are not large enough to achieve all coordination economies.

Those who propose deregulation argue that it is possible both to have numerous independent generating entities and to exploit fully the coordination economies at the system level. They suggest that we separate the transmission, load dispatch, and system planning functions from the existing utilities and *integrate* them into a single large transmission/coordination entity. The notion is that this entity would play the primary role in coordinating the economic generation and transmission of electric power in both the short and long run. It would merge the load dispatch and system planning efforts of many utilities into a single utility and replace existing power pools. It would use price signals to dispatch the most economic generating plants in a region to meet loads at each point in time, and it would ask existing firms or new entrants to submit bids to build new capacity (peak, cycling, or base load) and choose the lowest bidders. The transmission/coordination entity would then resell the power to local distribution companies.

This vision assumes that the price system can efficiently coordinate existing generating capacity in order to provide power reliably at least cost for a region. Under the existing system, utilities in each region form power pools, more or less formal entities designed to see to it that power is generated at, and dispatched from, the most efficient plants first. There are many complicated technical problems associated with dispatching a large set of dispersed generating plants economically and reliably.

**Whether the price system can efficiently decentralize the short-run coordination of generating plants remains an open question.**

Whether the price system can efficiently decentralize the short-run coordination of generating plants remains an open question. Further information about coordination within existing power pools could help to apply some real world observations on what is still a theoretical possibility.

But deregulators always face the "what if" and "who will coordinate things" questions. Their answer: it is assumed that the market will solve these problems and, further, that if it does not do so efficiently, we can always introduce regulation to meet such specific problems as emerge. Whether this would be the case in



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the electric utility industry I do not know. Nor, it is fair to say, does either side of the debate. Unfortunately, we all have beliefs, but little knowledge. My own view is that *if* we can satisfy ourselves that entry into generation would be on a sufficient scale to permit effective competition, and *if* we can have some assurance of sensible regulation at the transmission and distribution levels, we market economists should follow our beliefs and assume that the coordination problem will solve itself.

## Would Effective Competition Emerge?

The premise of all deregulatory proposals is that effective competition is possible and will evolve as the consumer's protector when regulation is ended. We can never, of course, be absolutely certain that a proposed change will produce the desired result: to put such a burden of proof on the proponents of change would only ensure perpetuation of the status quo. But neither should the reformers blindly assume that a particular effect will follow: we must weigh, as best we can, the odds of achieving the stated objective.

What are the odds that deregulation will result in truly competitive markets for electric power? Members of the financial community—and this includes people who claim they can raise capital for independently owned generating stations—uniformly say that financing of those stations would be possible only with take-or-pay contracts from utilities providing full payout of the facility over its estimated life. (Why such a contract would be more "bankable" than the utility's bonds is difficult to understand, unless it contained dollar-for-dollar cost escalators.) If such contracts are a sine qua non of financing, precisely what kind of competition are we hoping for? Several generating companies would be selling to a monopsonist—the transmission company. The latter would resell the power at cost-plus regulated rates to tied distributors, themselves regulated monopolists. Much of the electricity passing through this generator-to-transmitter-to-distributor-to-customer chain would originate under long-term, life-of-facility contracts. Whether this would lead to improvements in efficiency, as compared with the present system, is not at all clear.

## Would the Regulators Let Competition Work?

In all scenarios for electric utility deregulation, it is assumed that distribution remains a natural monopoly, in need of continued local regulation. The regulators would have two choices. One would be to permit distributors to pass through the costs of purchased power, on the theory that (1) competition at the generation level was effective enough to protect distributors and their customers from extortion and (2) distributors purchased efficiently. But this would leave distributors with what regulators would almost certainly view as inadequate incentives to purchase at minimum cost. So regulators would face an irresistible temptation to opt for their second choice—to extend their reach and review the prudence and propriety of the distributors' purchases. What would they find? That competing independent generators had an appallingly high target rate of return on equity, that their debt/equity ratios seemed far too low, and that perhaps the distributor could have somehow acquired power—or built generating capacity (!)— more cheaply. Is it reasonable to assume that the same regulators who have brought the electric utility industry to its present condition of penury would simply allow the distributors to pass along such higher purchase costs, especially if those higher costs included what would seem like very substantial profits to the generating companies?

**Is it reasonable to assume that the same regulators who have brought the electric utility industry to its present condition of penury would simply allow the distributors to pass along such higher purchase costs . . .?**

My own suspicion is that regulators would reach back into the supply chain and attempt to regulate prices paid by distributors.

## Conclusion

So, where are we? Clearly, the case for deregulation has not yet been made, even in the view of an economist who favors market-determined solutions over the decisions of the wis-



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est regulators. But, equally clearly, regulation is not working. What should be done?

First, although we now lack a detailed, workable prescription for a deregulation scheme that has a high probability of providing both effective competition and efficient coordination of operating and investment decisions, it may, indeed, be possible to write one. The stakes involved make it well worth a try.

Second, it is entirely possible that we already have at hand a less radical solution to some of the problems created by regulation—in particular, the purported lack of incentive to efficiency. If we were to allow free entry into the field of electric power generation, with utilities required to purchase from anyone who can sell power cheaper than the utility itself can produce it, we would get both the most efficient technologies and plants, and avoid such excessive construction as may be made possible only by the integrated structure of the industry. Moreover, if industrial and other large customers were free to shop for power and had assured access to a sufficiently large number of suppliers and to transmission facilities for any bargains they found, we could deregulate sales to those customers. Here, FERC could play an important role. It can test its authority to improve the efficiency of resource allocation by deregulating sales to wholesale buyers in situations where competition for such sales is likely to be effective. Or, it can continue to regulate, but insist on marginal-cost pricing.

Third, while we are thinking about and testing new ideas for some deregulation, we must continue efforts to make the existing system work better, to persuade regulators that the public interest is not served by keeping rates so low that an economic supply of power is threatened.

The issue of electric utility deregulation is clearly not so simple as that of airline deregulation. In the airline industry, potential entrants were queued up, assets were easily transferable from market to market, and entry lead times were short. Not so in the electric power business, where existing firms are trying to diversify out of the business, where assets don't have wings, and where entry times are as long as twelve years. But the status quo is so unacceptable to all parties at interest—regulators, consumers, and the utilities—that deregulation must be fully explored. ■

**Biting the Hand that Cures Them**

*(Continued from page 18)*

tions can do that. At a recent international conference in London on economic development, the Pakistani director of the Third World Institute, Altaf Gauhar, compared the need for WHO to regulate international drug products with an adult's need to force a child to bathe.

The institutional infancy to which Gauhar refers can hardly consist of an inability to enforce drug restrictions. In areas where compliance cannot be ensured by drug companies' voluntary observance of the law (which there is no reason to believe is any less forthcoming in the undeveloped countries), the developed countries themselves are not notably proficient in enforcement. There may be more illegal drugs on the streets of Chicago than Istanbul. It is difficult, of course, for many third world countries to do their own testing to identify harmful drugs, although some—Singapore, for example—do have quite sophisticated drug approval agencies. But any underdeveloped country can adopt the drug approval decisions of some other nation—say, of Great Britain, France, or Switzerland—just as easily as it could adopt some newly created international approval mechanism. In fact, some have already done so. Even more to the point, there can hardly be any justification for an international scheme that will tell Germany and Italy what they must do, in addition to doing for Uganda what it cannot do for itself.

WHEN ALL IS SAID AND DONE, however, the fundamental point is that drug approval is neither (1) an exact medical science, nor (2) directed to the same medical conditions and necessities in all countries of the world, nor even (3) free from value judgments that are political and have nothing to do with science at all. With thousands of products to consider, it is no surprise at all to find the experts differing sharply, within the United States, among the various developed countries, and between developing and developed states. The drug industry is already one of the most strictly regulated industries in the world; international regulation would add another, and quite damaging, layer. Indeed, if there is any area that does not recommend itself to uniform international treatment, this one is it. ■



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# Deregulation– A Green Light for Trucking Efficiency

**Robert E. Mabley**
**Walter D. Strack**

THE MOTOR CARRIER ACT of 1980 broadened the reform of trucking regulation initiated in the mid-1970s by the Interstate Commerce Commission (ICC). But it did not go all the way. The commission still (1) restricts entry into the industry, (2) regulates prices, and (3) requires truckers to serve all shippers who want to use the service offered at the prescribed rates. The third of these can, of course, be looked at as giving force to the first two, which are at the heart of ICC regulation.

Before the commission began its own reforms, the industry was by and large happy with what it had, and when the question of reform came up would ask, in effect, "Why tamper with success, particularly ours?" Students of the industry (including, but not limited to, a number of practicing economists) argued that consumers would benefit from reform through better service and lower prices. We have now had three years of ICC-directed reform, followed by two years under the Motor Carrier Act of 1980, and while not all the results are yet in, it is possible to come up with some preliminary conclusions. Ours—not necessarily the ICC's—are given in what follows.

In evaluating the effect of regulatory reform on the industry, the condition of the economy must be considered. U.S. economic activity directly affects trucking tonnage and hence the industry's health. Distinguishing between the effects of back-to-back recessions and the effects of regulatory reform is difficult. Regulatory reform has had significant effects, but so too has the severe and prolonged drop in industrial production and in trucking tonnage from 1979 to the present. Industrial production fell sharply in 1980, rebounded weakly, then dropped off again in late 1981; in the first quarter of 1982, it stood about 9 percent below 1979 levels. Intercity truck tonnage fell about 18 percent from 1979 to 1980; it currently stands about 34 percent lower than 1979's highest volume and about 12 percent below the first quarter of 1981.

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## Trucking Regulatory Reform

Regulatory reform began in the mid-1970s when, on its own, the ICC took significant administrative steps to reduce trucking regulation. A series of decisions made entry freer. New firms could more easily obtain permission



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to begin operations, and existing firms could more easily expand into new markets. In addition, the commission began a review of the competitive effects of collective ratemaking and antitrust immunity. It also changed rate bureau procedures to promote individual carrier pricing and launched a search for a better way to evaluate requests for collective rate increases.

The 1980 act further lessened the evidentiary burden placed on applicants and speeded up administrative processing. It also increased rate flexibility and encouraged independent pricing by establishing a "zone of ratemaking freedom" within which carriers can adjust their rates without commission approval. Third, it eliminated or reduced such regulations as those requiring circuitous rather than direct routes. Finally, it provided for the phased elimination of most collective ratemaking, and established an independent study commission to look closely into the effects and desirability of any antitrust immunity for collective ratemaking.

On the very day that these reforms of interstate trucking were enacted at the federal level, a more sweeping change occurred at the state level. On July 1, 1980, Florida totally deregulated trucking and busing within the state. No entry or rate controls now remain, and carriers need only satisfy the state's safety rules. Along with looking at the data on interstate trucking, we will review here some results of the early Florida experience.

Ever since regulatory reform was contemplated, there has been concern about its effects in three main areas. These are—in the order that we now take them up—rates, service to small communities, and industry structure.

## The Effect of Reform on Rates

The trucking industry generally seems to have been unsure of the effects of increased rate flexibility and increased competition from freer entry. On the one hand, industry representatives argued that more trucks would compete for the same amount of traffic, average load size would fall, and rates would have to be increased. On the other hand, they argued that large shippers would be able to extract lower rates from carriers, and thus would be subsidized by the small shippers, which would be discriminatory.

Students of the industry having an outside vantage point (we may call them economists for convenience), taking issue with both of these positions, argued that rates would become based on costs and that, since regulated rates include monopoly profits from restricted competition, rates would fall to their natural levels. (Carriers collectively set rates on groups of commodities, by value as well as cost, with the result that high-valued commodities might have rates higher than their costs of shipments justify—or so the economists argued.) Both sides agreed there would be rate restructuring, but the industry thought substantial overall reductions were unlikely, while the economists thought they were quite likely indeed.

As the economists predicted, rates either have fallen or are increasing less rapidly than they were before regulatory reform. Admittedly, circumstances vary, but in many cases real rates are down, and in some cases nominal rates are down as well. In addition, there is little question that many of the rate restructurings that have taken place represent movement toward cost-based rates.

No measure of the overall rate level exists, partly because the structure is so complex. But

**. . . rates either have fallen or are increasing less rapidly than they were before regulatory reform. . . . In addition, there is little question that many of the rate restructurings that have taken place represent movement toward cost-based rates.**

a series of monitoring reports from the ICC's (former) Office of Policy and Analysis leaves no doubt about the trend. These reports keep track of all aspects of industry activity, using information gathered from trade publications, general business publications, rate filings, and telephone conversations with carriers, rate bureaus, and shippers. While the evidence is to some extent anecdotal rather than quantitative, we find it convincing.

We note that changes have generally come not in the form of collective rate decreases (or smaller increases), but in a proliferation of individual rates set lower than the collective rates. Carriers have not taken advantage of the



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"zone of ratemaking freedom" thrust upon them, but have employed the established procedures for individual rate adjustments through rate bureaus—whether for across-the-board cutting or for cost-based rate restructuring.

Other carrier strategies range from across-the-board rate reductions to cost-based restructuring of particular rates. Overnite Transportation, for example, cut its rates 10 percent across-the-board. Often the rate changes are accompanied by new marketing strategies or new price/service combinations. Transcon Lines combined guaranteed service (with late delivery penalties of up to 20 percent) with a 20 percent discount. Volume discounts and discounts to fill empty back hauls (return trips) have become particularly common.

"Multiple tender discounts" are another good example of the trend toward cost-based rates. These are discounts given when a shipper has several shipments—going to different destinations—picked up at the same time. Until recently, the charge to a shipper was typically the same whether a carrier had to make one pickup of several shipments or several individual pickups. Yellow Freight System's multiple tender discounts, for example, range from 3 to 20 percent depending on the shipment's total weight.

Table 1 measures the rate effects of regulatory reform by comparing the number of independent rate proposals made by members of the ten major trucking rate bureaus from 1975 through 1981. Almost all the proposals were, in fact, rate reductions. Comparisons among bureaus are vitiated by lack of uniformity in the way the different bureaus count independent proposals; each bureau should be considered separately. While not all bureaus show a systematic increase in independent proposals over time, in each case, a bureau's 1980 total is higher than the figure for any year from 1975 to 1979. From 1979 to 1980 the increases ranged from 44 percent to 347 percent and the total number of independent actions increased 123 percent. From 1980 to 1981, the total number of proposals increased 90 percent, while individual bureau proposals increased as much as 1,442 percent. In all, the average number of proposals was 20,685 for the years 1975–79 and 87,842 for 1980–81.

**Table 1**

NUMBER OF INDEPENDENT RATE PROPOSALS AT MAJOR RATE BUREAUS, 1975 THROUGH 1981

| Rate Bureau | 1975 | 1979 | 1975–79 Average | 1980 | 1981 |
|---|---|---|---|---|---|
| Central & Southern | 1,073 | 686 | 794 | 2,035 | 7,253 |
| Central States | NA | 1,621 | 1,691 | 2,744 | 7,126 |
| Eastern Central | 1,503 | NA | 1,301 | 2,051 | 6,877 |
| Middle Atlantic | 1,340 | 2,160 | 2,078 | 3,117 | 7,827 |
| Middlewest | 1,834 | 19,072 | 10,352 | 40,845 | 55,883 |
| New England | 492 | 561 | 507 | 949 | 1,505 |
| Niagara Frontier | 0 | 25 | 8 | 45 | 694 |
| Pacific Inland | 37 | NA | 28 | 100 | 253 |
| Rocky Mountain | 613 | 295 | 452 | 1,318 | 13,921 |
| Southern | 4,457 | 2,721 | 3,474 | 6,396 | 13,746 |
| Total | 11,349 | 27,141 | 20,685 | 60,600 | 115,085 |

**Source:** ICC, Rate Bureaus and Organizations Annual Reports.

Early experience in Florida suggests that intrastate rates in that totally deregulated environment are down as well. One ICC study provides some actual rate data on eight origin-destination pairs, movements from Tampa to eight different destinations in Florida. These movements were of varying lengths and to cities of varying sizes. For each city pair, nine rates were reported, covering three different shipment sizes, and for each size, three different classes of commodities. The results are given in Table 2. Most of the seventy-two rates are down in nominal terms between March 1980 and March 1981, and virtually all of them decreased in real terms. The biggest reductions occurred in the highest classes (class 100 and class 150), which get the highest rates. These are the rates on commodities that reform advocates have argued are discriminated against. While these data cannot be taken to represent rate changes throughout all of Florida, they are consistent with the reformers' claim that the collective ratemaking system discriminates against high value commodities and that rates on those commodities—having been set furthest above cost —will fall the most with deregulation.

While everyone agrees that the rates are decreasing (or at least increasing at a decreasing rate), some industry observers have argued that rate reductions have come about because of the depressed economy rather than the new legislation. Quite likely this is true in part, but a comparison of 1975 (the last economic downturn) with 1980 and 1981 shows the level of independent proposals in the latter years to be higher in every case (where data are available). ICC administrative actions in 1978 and 1979, reforming rate bureau procedures and (concomitantly) relaxing entry requirements, plau-



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**Table 2**

CHANGES IN NOMINAL RATES ON SHIPMENTS FROM TAMPA, FLORIDA, TO EIGHT DESTINATIONS IN FLORIDA, MARCH 1980 TO MARCH 1981

(population in parentheses)

| | Percentage Changes | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Shipments** | Jacksonville (565,000) | Orlando (118,000) | Sarasota (46,000) | Leesburg (11,869) | Miami (345,000) | St. Petersburg (236,000) | De Funiak Springs (4,966) | Immoka-lee (3,764) |
| 250 lbs., 3 pieces | | | | | | | | |
| Class 55 | 2.7% | 2.5% | 2.5% | 2.5% | 15.0% | 2.5% | 45.0% | 2.5% |
| Class 100 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 | 3.6 | 2.4 |
| Class 150 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 |
| 450 lbs., 2 pieces | | | | | | | | |
| Class 55 | −2.5 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 |
| Class 100 | −25.7 | −24.6 | −28.2 | −27.0 | 2.5 | −10.0 | 2.5 | −24.5 |
| Class 150 | −47.7 | −12.4 | −47.2 | −47.3 | 0.6 | −37.0 | 2.5 | −46.6 |
| 5800 lbs., 6 pieces | | | | | | | | |
| Class 55 | −14.6 | −2.6 | −2.6 | −2.6 | −2.6 | −2.6 | −2.6 | −2.6 |
| Class 100 | −29.9 | −27.0 | −31.0 | −31.0 | −2.6 | −11.5 | −2.6 | −31.0 |
| Class 150 | −53.1 | −51.2 | −54.2 | −53.8 | −2.6 | −41.1 | −2.6 | −53.6 |

**Source:** ICC, *Initial Carrier and Shipper Responses to Interstate Trucking Deregulation in Florida*, p. 10; population figures from Rand McNally, *1978 Commercial Atlas & Market Guide.*

sibly account for the difference in independent pricing conduct between 1975 and the current period.

More concrete evidence that reform has affected rates is provided by the fall in the value of carrier operating rights. These rights—a carrier's permission to operate in a regulated trucking market—can be bought and sold in the marketplace. Their market value is the present value of future profits to be made in the industry, above and beyond what could be made in other industries (the "normal" rate of profit). Since the passage of the Motor Carrier Act of 1980, these operating rights have lost virtually all their value, though some purchases continue. Recognizing this loss in value, the Financial Accounting Standards Board (FASB), which establishes accounting rules for the industry generally, has ruled that, because of the act, the value of all interstate rights on a carrier's books should be reduced to zero. If carried out, this means that roughly $775 million will have been written off by carriers whose annual revenues exceed $1 million each. But this is only part of the iceberg. Many carrier rights have never been sold, which means that they do not appear on the books at all: the American Trucking Associations have estimated that the real value of operating rights was between 15 and 20 percent of carriers' annual revenue—or between $5.1 and $6.8 *billion* for the class of carriers whose annual revenues exceed $1 million each. To say the least, this is a figure large enough to have reflected significant above-normal profits, and thus higher rates.

An economic downturn alone would not have produced this (say) $6 billion loss. Freer entry and freer pricing policies together have forced the present value of future above-normal profits in the industry toward zero. At least to this extent there is evidence that rate decreases are directly attributable to regulatory reform rather than to the economic downturn. Thomas Gale Moore, appearing before the Joint Economic Committee in January 1982, stated that operating rights have regained market value since the summer of 1981. There is no evidence, however, that rights have attained a significant fraction of their former value. Wilson Freight Company, for example, paid $2.4 million for Cincinnati–to–Atlanta rights six years ago and recently sold that authority for $6,000.

## The Effect of Reform on Small-Community Service

We have noted that both administrative reforms before 1980 and the Motor Carrier Act itself reduced barriers to entry: the expected effect would be an increase in competition, reducing profits to "normal" levels. Industry advocates argued that the increased competition would force carriers to reduce or eliminate service to small communities, because (they insisted) that service was cross-subsidized by



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profits on service to large communities. Small communities that continued to get service might be charged rates above what was "fair and reasonable." But since the ICC had always permitted the dropping of unprofitable service, and had *never* revoked a carrier's authority for failure to fulfill common-carrier obligations in a money-losing market—so, at least, the economists argued—this worry was overstated, if not pure chimera. In fact, the economists argued, with freer entry, new efficient carriers would begin serving smaller communities.

Fortunately, the accuracy of the two sides' projected results can be determined empirically. An ICC survey of 1,200 shippers in small communities across the nation shows that shippers generally believe that both the availability and quality of service improved after the law was passed. Questionnaires were mailed out in January 1981, July 1981, and January 1982. Table 3 summarizes some of the key results from the survey's latest phase. Specifically, 10.0 percent said availability had improved, 3.3 percent said it had declined, and 86.7 percent reported no change. Similarly, averaging among the four quality measures, we could say that somewhere around 9 to 10 percent thought quality improved, perhaps 2 to 3 percent thought it worse, and 87 to 89 percent found no significant change. Indeed, only on one quality measure—ease of claim resolution—was there a negative change.

**An ICC survey of 1,200 shippers in small communities across the nation shows that shippers generally believe that both the availability and quality of service improved after the law was passed.**

ICC complaint records also shed light on the small-community service issue, and these records show no increase in service problems. Instead, the absolute number of small-community service complaints was lower in October 1980 than in October 1979, and the proportion of small-community service complaints to total service complaints remained constant. One problem is that we lack the data to determine the direction and significance of small-community rate changes, if any, though the Florida data (Table 2) suggest rate reductions to the small communities there.

**Table 3**
SHIPPERS' EVALUATION OF CHANGES IN ASPECTS OF SERVICE TO SMALL COMMUNITIES

| Type of Shipper | Service Aspect | Percentage Answering— Better or more | About the same | Worse or fewer |
|---|---|---|---|---|
| Receivers of freight | Availability | 10.0 | 86.7 | 3.3 |
| | On-time performance | 12.0 | 86.0 | 2.0 |
| | Lack of damage/loss | 14.4 | 82.5 | 3.0 |
| | Ease of claim resolution | 2.8 | 93.4 | 3.8 |
| | Service options | 5.9 | 92.1 | 2.0 |
| Senders of freight | Availability | 8.7 | 89.3 | 2.0 |
| | On-time performance | 9.6 | 88.1 | 2.3 |
| | Lack of damage/loss | 7.0 | 92.6 | 0.4 |
| | Ease of claim resolution | 2.5 | 96.7 | 0.7 |
| | Service options | 9.1 | 88.1 | 2.1 |

**Source:** ICC, *Small Community Service Study*, forthcoming, September 1982.

## The Effect of Reform on Industry Structure

The trucking industry seemed generally to believe that reform would bring a host of undercapitalized—and cream-skimming—small carriers into the industry. Many of these carriers would price their services below costs, stimulating rate wars. They would eventually fail, but in the meantime they would drive other "responsible" carriers out, and the net long-term effect would be increased concentration. After the shakeout most of the industry would be dominated by a handful of large carriers, free to charge quasi-monopoly prices. In short, there would be destructive competition and predation.

Economists outside the industry argued that low fixed costs (relative to total costs) and the ability to change capacity relatively quickly meant that carriers profitable in the long run could not be driven out of the market in the short run. Moreover (they argued), since—over a broad range of firm sizes—large trucking firms enjoy no cost advantages over smaller firms simply as a result of their size, large firms would not drive efficient small firms out of the market. Competition would simply enable efficient firms to drive out inefficient firms.

Once again, we can come up with an empirical answer to the destructive competition



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question, just as we came up with an empirical answer to the small community question. It should be noted here that, even if the long-range effect of regulatory reform were to reduce the number of carriers, this would not necessarily reduce the number of competitors, and certainly would not necessarily reduce competition. The trucking industry does not consist of a single market but of a complex set of interrelated markets covering different commodity groups and territories. If regulatory reform produces a smaller number of firms, each operating in a greater number of markets, then there can be more firms and less concentration (greater competition) in every market, even though there are fewer firms in the industry overall.

Our empirical tests here are several—profitability of firms (as an indication of possible destructive competition), the number of firms in the industry (as an indication of possible increased concentration), and the number of applications for additional or new authority granted (as a direct measure of increased competition). None of these is a perfect measure, but taken together they should give us some idea of the effect of reform on industry structure.

For profitability let us consider the operating ratio (operating expenses as a percent of operating revenues) for a sample of general freight carriers each with at least $1 million in revenue. This ratio was 96.4 percent for 1980, slightly better than the 96.6 percent for 1979 and the 96.7 percent for the previous recession year of 1975; but for 1981 it rose to 97.7 percent. Not all carriers, however, did poorly in 1981. According to a Citibank report, the twenty-one carriers that are publicly traded had a 25.3 percent return on net worth in the past calendar year. Certainly these pieces of evidence point away from any harm having accrued to the structure of the industry as a result of reform.

Trucking profits historically rise and fall with general economic activity. The industry rebounded strongly from its slump during the 1975 recession and had relatively high profits in the late seventies. Its current slump is comparable in severity to that of 1975, and there is no evidence the industry will not rebound with the general economy. Yet, since regulated carriers no longer earn monopoly profits, their profit levels may never return to the levels prevailing before the act.

Some large-firm failures have been well publicized, but whether the overall rate of exit since the act passed has been abnormally high (given the state of the economy) is unclear. For one thing, exit data are poor. The ICC has discredited figures from the Teamsters showing a high number of failures, and similar findings by the ATA have not been verified independently. Second, the meaning of the exit rate is clouded further because the Multi-Employer Pension Plan Amendments Act of 1980 greatly increases carriers' pension liabilities, thus discouraging carriers from going out of business. Industry observers believe the carrier failure rate would be substantially higher were it not for that act. Even with the act, the failure rate is probably high. But with general business failures now at a post-depression high, the economy would seem to be the main culprit. The General Accounting Office recently released a report concluding that "poor economic conditions, not regulatory reform, have been the likely cause of high unemployment in the trucking industry."

**[The trucking industry's] current slump is comparable in severity to that of 1975, and there is no evidence the industry will not rebound with the general economy.**

A high failure rate is not a priori evidence of destructive competition. Exit from the industry is destructive only if capacity needed in the long run is being forced out in the short. It is constructive if it represents the market's natural tendency to rid itself of unneeded capacity. To judge whether an above-normal rate of exit is destructive or constructive, given the short time since the act has passed and given that we do not know if there has been an above-normal rate, would be rather like trying to guess the color of a purely hypothetical pig in a purely hypothetical poke.

Fortunately, we have better tests for concentration and competition. As Table 4 shows, the number of regulated carriers in the industry has been increasing in recent years, moving from 17,083 in 1979 to 22,270 in 1981. Interest-



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ingly, Class III carriers (those with under $1 million in annual operating revenue) showed the greatest increase. However, the number of Class I carriers (the largest carriers) rose 4

**... the number of regulated carriers in the industry has been increasing ..., moving from 17,083 in 1979 to 22,270 in 1981. [Small carriers] showed the greatest increase.**

percent from 1979 to 1981, despite a rise in the Class I revenue requirements from $3 million to $5 million in 1980. Also, as Table 5 shows, the total number of applications decided each year and the number granted as a whole or in part have both increased dramatically. Specifically, the percentage of decided applications granted wholly or partly rose from 69.8 percent in 1976 to 96.7 percent in 1981 and 97.5 percent in the first half of 1982. The grants are for carriers of all sizes, for hauling general commodities as well as specialized commodities requiring specialized equipment, and for all geographic regions. They are for both small-shipment operations, which require consolidation and distribution through terminals, and large-shipment operations, which do not. While most of the grants have gone to existing carriers expanding into new markets, a significant portion —in 1981, some 3,782 grants or 13.3 percent— has gone to newcomers (mostly for large-shipment or truckload operations). So far in 1982, 3,121 decisions have involved newcomers.

Moreover, the figures in Table 5 understate the actual increase in entry into individual markets because authority grants are broader and less restrictive now than they were before regulatory reform. Broader grants of authority translate into more direct competition among carriers. A study of application samples has shown that authority applications contained fewer restrictions in 1981 than in 1976 or 1980 —most notably in the matter of one-way authority. While 84 percent of the 1976 and 49 percent of the 1980 applications were for authority to haul in one direction only, none of the 1981 applications had this restriction. (Largely because of changes in the makeup of the commission, grants appear to have become somewhat more restrictive in fiscal 1982 than they were immediately after passage of the act. Some grants have been restricted to territories and commodities specifically described by shippers supporting the application. Nonetheless, grants remain significantly broader than they were before the advent of reform.) In addition, through June 1982, some 5,000 carriers succeed-

*(Continues on page 56)*

**Table 4**
NUMBER OF REGULATED TRUCKING FIRMS BY SIZE, 1979–81

| | | | | Percentage Change | |
|---|---|---|---|---|---|
| **Class[a]** | **1979** | **1980** | **1981** | 1979–81 | 1980–81 |
| Class I | 992 | 947 | 1,031 | + 3.9 | + 8.9 |
| Class II | 2,754 | 2,164 | 2,293 | –16.7 | + 6.0 |
| Class III | 13,337 | 14,610 | 18,563 | +39.2 | +27.1 |
| Total | 17,083 | 18,045[b] | 22,270[c] | +30.4 | +23.4 |

**Note:** The figures in this table are ICC estimates and do not reconcile with Table 5's figures on new carrier authority grants.
**a** Class I includes carriers with annual operating revenues in excess of $3 million in 1979, and of $5 million in 1980 and 1981; Class II includes those with annual operating revenues between $500,000 and $3 million in 1979, and between $1 million and $5 million in 1980 and 1981.
**b** Includes 324 Class I and II carriers relieved from reporting requirements.
**c** Includes 383 Class I and II carriers relieved from reporting requirements.
**Source:** ICC annual reports.

**Table 5**
OPERATING AUTHORITY APPLICATIONS, 1976–82

| | Number of Applications Decided | | Number of Applications Granted as a Whole or in Part | | Percent Granted | |
|---|---|---|---|---|---|---|
| **Fiscal Year** | All firms | New firms only | All firms | New firms only | All firms | New firms only |
| 1976 | 6,746 | 558 | 4,710 | 468 | 69.8 | 83.9 |
| Transition quarter | 1,308 | 224 | 958 | 156 | 73.2 | 69.7 |
| 1977 | 7,848 | 1,161 | 6,038 | 850 | 77.0 | 73.2 |
| 1978 | 9,767 | 629 | 8,684 | 528 | 88.9 | 83.9 |
| 1979 | 12,744 | 748 | 12,233 | 689 | 94.5 | 92.1 |
| 1980 | 22,735 | 1,461 | 22,125 | 1,423 | 97.4 | 97.4 |
| 1981 | 28,414 | 3,782 | 27,475 | 3,702 | 96.7 | 97.9 |
| 1982 (first 6 months) | 7,968 | 3,121 | 7,771 | 3,017 | 97.5 | 96.7 |

**Source:** ICC, Office of Proceedings.



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SEA OF TROUBLES

# Managing New England's Fisheries

## Christopher H. Foreman

When President Gerald Ford reluctantly signed the Fishery Conservation and Management Act of 1976, our coastal fishermen, conservationists, and fishery scientists rejoiced. At last, they said, America's offshore fishing grounds would be rescued from the rapacity of Soviet, Japanese, and other foreign fleets that had been systematically scooping up cod, haddock, salmon, and other valuable species since the early 1960s. The new fishery act, which asserted U.S. jurisdiction over all fish stocks (except tuna) within a fishery conservation zone extending two hundred miles from our coast, would put a stop to all that.

The foreign fleets, it was charged, enjoyed unfair advantages. Because they were either heavily subsidized or owned outright by their governments, they could afford state-of-the-art equipment: large, efficient stern trawlers and processing vessels that could easily outwork the smaller, older side trawlers the Americans used. Also, they often engaged in "pulse fishing"—focusing on a particularly inviting patch of ocean and hauling up almost anything harboring usable protein. Americans who used fixed gear (shellfish traps or gill nets deployed for later retrieval) frequently returned to find their gear in shreds and pointed accusing fingers at "the foreigners." Some fishermen even related tales of face-to-face intimidation.

Between 1960 and 1970 the Americans' share of the harvest on New England's fertile Georges Bank had declined from 88 percent to 10 percent. In the same period, the Americans watched their 100 percent share of the catch off southern New England slide to a mere 12 percent. And while the United States had imported only 23 percent of its seafood in 1950, the proportion had swelled to over 60 percent by 1972. In 1974, Dr. William J. Hargis of the Virginia Institute of Marine Science told a House committee that the American offshore fishery "cannot long survive if conditions are not improved." In 1975 a Commerce Department report blamed the overfishing of Atlantic mackerel, haddock, and yellowtail flounder primarily on foreign fleets. It is no wonder that by the mid-1970s, coastal fishermen were crying loudly for relief.

Such warnings and concerns helped spur passage of the fishery act, the first comprehensive program of fisheries regulation ever attempted by the federal government. In many respects, the act did improve matters. Certainly, it reduced offshore fishing by foreign fleets. By June 1978, the Commerce Department's National Oceanic and Atmospheric Administration (NOAA) could report to Congress that there were only 570 foreign fishing vessels operating within 200 miles of our shores, compared with 2,700 in 1975. And by 1980 the total foreign catch in the conservation zone had fallen to a little over 1.6 million metric tons, some 22 percent below the 1974–78 average.

In New England, the act allowed us to shut out all except Canadian competition for species that are of particular interest to American fishermen (such as cod, haddock, and yellowtail flounder), and to control the foreigners' take of

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less-favored species (such as hake or squid). As a result, total New England commercial landings grew from about 230,000 metric tons valued at $150 million in 1975 to 360,000 tons valued at $326 million in 1980.

Nevertheless, serious difficulties abound, particularly in New England. After five years of operation, the fishery act's creaky regulatory apparatus satisfies no one. The reason is that it not only subjects foreigners to controls, but regulates domestic harvesters as well—and so badly as to leave serious doubt that it can safeguard our long-term supply of fish. Let us see why.

## Fisheries and Fishermen

In explaining why fisheries pose such a difficult problem, economists emphasize their "common property" nature. Because the fish are unowned, individual harvesters have an incentive to enter the fishery and grab all they can as swiftly as possible, as long as there is any profit in doing so. Thus, in the absence of appropriate regulatory measures, depletion is inevitable. The same principle applies to public grazing land or pools of oil. In effect, the exploitation of a common property resource is a "war of all against all" that can destroy long-term productivity and profitability.

Another real headache for policy makers arises from the simple fact of resource diversity. The basic distinction between finfish and shellfish is just the beginning. Over 200 species are harvested by U.S. fishermen and each has its special character. Of course, most of the fishing effort is taken up by a relative handful of these—shrimp, salmon, tuna, flounder, crabs, lobsters, clams, oysters, and scallops. A single species, however, is often composed of several geographically distinct stocks, each of which fishery managers must analyze and regulate separately. What is more, any given stock may display significant, but inexplicable, changes over time in its growth rates, reproduction, mortality, habitats, and feeding habits. Moreover, fish are the most mobile of the world's commonly owned creatures. Trees are stationary, and even cattle can only wander off in two dimensions. But fish, aside from salmon and a few other species, are extremely difficult to count or track. In these circumstances, fishery scientists can ordinarily make only educated guesses about what stocks (and how many of each) will be available for harvesting at any given point in the future.

Predicting future stocks of fish would be difficult enough if there were only the fish to think about. But out there in the relative isolation of the vast ocean there are humans as well. Nobody knows exactly how many American commercial fishermen there are, but government estimates put the number at about 180,000, half of them fishing full-time. These fishermen are almost as varied as the fish. Some ply their trade a mile or so from the coast (within state waters), others at a considerable distance from land. Some pursue demersal (bottom-dwelling) species like cod or flounder, others try for mid-water species such as herring or mackerel. Some fish with trawls, others with fixed gear, methods that are incompatible when used in the same area. One thing most fishermen share, however, is deep resentment of any outside meddling with their livelihood. Many New Englanders, for example, strongly resisted a recent attempt by the National Marine Fisheries Service (a part of NOAA) to impose a logbook system for collecting catch data. Indeed, for a lot of fishermen, it is now the government regulator, rather than the foreigner, who is the major nuisance.

## Regulatory Tools

Section 303 of the fishery act provides that a "fishery management plan" (of which, more later) may use any or all of the following devices to control catch rates.

*Closed areas and closed seasons.* At certain places or times, fishing is banned in order to protect either spawning or juvenile stocks in areas where the population is lagging. Such closures have the advantages of being easy to enforce—a vessel's mere presence in the forbidden zone renders it suspect—and being comprehensible to fishermen. But, say some economists, closures are costly, compared with less drastic methods of restricting the take, since fishermen will have to go greater distances or concentrate their effort during the open seasons when the stocks are dispersed. As long as demand is sufficient to render a fishery profitable, a closure will simply increase the fishing



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pressure on whatever tract of ocean or period of time is not closed. The area or duration of the closure can, of course, be increased to compensate for this—a poor solution at best since it only intensifies the pressure on the rest.

*Gear regulation.* For the trawl fisheries of the northwest Atlantic, this generally means imposing a minimum permissible mesh size for the nets. Here, again, the purpose is to protect future yields by allowing undersized fish to escape. A major problem with mesh regulations is enforcement: although each vessel's equipment may be inspected, the determined violator can hide an illegal mesh from even the most energetic inspector. In a "mixed trawl" fishery (an area inhabited by different species), gear regulation problems are compounded. If New England fishermen are required to use a larger mesh so as to avoid taking juvenile cod or haddock, they will not be able to catch adult hake —a smaller fish that, far from being overfished, is considered "underutilized." Moreover, like closures, mesh regulations promote inefficiency by encouraging more intense fishing effort to compensate for the restriction.

*Size and sex limits.* These are aimed at protecting undersized fish and egg-bearing females. Size limits are particularly difficult to enforce in the case of finfish. Determining the proportion of a vessel's catch that is undersized can be impossible given the thousands of pounds of fish involved.

*Catch limits.* This approach, which normally means putting a limit on the overall harvest that can be taken from a fishery in a given period (say, a year), is also inefficient. Fishermen will simply race with one another to get a larger part of the limit. Thus, like the tools mentioned above, a catch limit directs too much money into the fishery, leaving it overcapitalized in slack periods.

In addition, catch limits, like size and sex limits and gear regulation, require that enforcement personnel inspect catches. The more places there are for fishermen to bring their catch, the more expensive and difficult this becomes. Moreover, fishermen can evade all restrictions of this sort by pretending that conservation zone catches are taken in state waters.

*Limited effort.* By far the most controversial regulatory device is a direct limit on the amount of fishing effort. One way to attempt this is to limit the number of vessels permitted to enter a given fishery. But this, like the earlier measures noted, and for the same reasons, is unlikely to ensure economic efficiency. A program of tradeable catch quotas for individual fishermen, on the other hand, addresses the common property problem more directly—which is why the economists prefer it. By creating what are in effect property rights in the fishery and by giving out "ownership portions" in the form of entry permits, it encourages harvesters to adopt a more "future-oriented" posture and thus encourages conservation. They need no longer worry about cut-throat competition; nor must they forgo the efficiency achievable through technological innovation (a major drawback of gear-regulation schemes).

Limited effort has been used successfully both in the United States and elsewhere. Alaska, for example, has operated a very popular tradeable permit program for its salmon fisheries since 1974. (In the Alaska case, the rights traded are not to a given quantity of fish but to a given tract of water, subject to the use of certain types of gear.) But the idea is hard to sell to fishermen because some will be left out. Is it right, they ask, for government to guarantee a living to some persons and bar others from the field?

## The Creaky Regulatory Process

The foregoing discussion makes it plain that fishery management brings problematic tools to a complex and uncertain task. Unfortunately, the regulatory process through which fisheries are managed only makes matters worse.

The problems begin with the statute. It strikes many persons as an effort to safeguard the resource, and indeed is largely that. But it also incorporates a desire to enhance the incomes of coastal fishermen. These interests *may* be coincident, as they are when both the fishermen and the resource are threatened by foreign predation or, more recently, offshore oil drilling. But more often there is a struggle between those claiming to speak for the fish and those claiming to speak for the fishermen.

What got fishery legislation on the congressional agenda was the economic malaise afflicting coastal fishermen. With the campaign originally led by members of Congress from coastal states, the early drafts of the bill were explicitly



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protectionist, calling for little more than an offshore fence to keep foreigners out. Soon, however, the proponents began talking in more broadly "conservationist" terms. Whether this was mostly a matter of strategy or of conviction, it added a new set of interests to the debate. Other persons, those with an intellectual or professional interest in fishery management, supported the bill mainly out of a desire to prevent overfishing. The National Marine Fisheries Service, which had long insisted that kicking the foreigners out was not an adequate response to the problem, fell into this group.

These differing perspectives were only superficially reconciled in the substantive and procedural requirements of the fishery act. The act required that management plans for fisheries in the conservation zone be designed to produce "optimum yield"—in this context a term of truly colossal vagueness. Thus, a plan must seek, first, to prevent "overfishing" and, then, to provide "the greatest overall benefit to the Nation," taking into account the food production, recreational opportunities, and "maximum sustainable yield" of the fishery, "as modified by any relevant economic, social, or ecological factor." In short, optimum yield can be virtually anything so long as the regulators consider a variety of values.

Other, and in some respects greater, problems arose from Congress's misplaced confidence in its ability to create regulatory machinery that could both handle that difficult assignment and, at the same time, reconcile the economic interests involved. To this end, Congress tried to "democratize" the regulatory process, while giving the federal bureaucracy a preeminent role in standard setting. The act established seven regional fishery management councils, each made up of representatives of the fishing industry, state fishery officials, and the regional director of the NMFS, plus some nonvoting members. Each council monitors the fisheries in its region and, subject to NMFS approval every step of the way, initiates and prepares management plans for any stocks it thinks need them. Such a plan specifies the optimal catch, based on "stock assessments" made by NMFS, and proposes a scheme of regulation. Once a plan is completed, NMFS drafts, promulgates, and (along with the Coast Guard) enforces the implementing regulations. The process involves publication of plans and environmental impact statements (draft and "preliminary final"), public hearings, public comment periods, regulatory analyses, repeated intradepartmental reviews, and so on—far more than is required under ordinary informal rulemaking.

On paper, the process takes 250 days from start to finish. But inevitably there are delays due to misunderstandings and miscalculations when theory translates into practice. In the meantime, the fishery may be changing dramatically, rendering the optimum yield figures unrealistic. And even though NMFS has asked the councils to write multi-year plans broad enough to permit easy adjustments, anything significant enough to rate the term "amendment" merely sends the entire process back to square one.

More basic difficulties stem from the political sensitivity of the councils. Congress created the council system largely to make the new regulatory scheme palatable to the industry. But industry in this case consists of not one but many interests—trawlers versus fixed-gear vessels, small boats versus large ones, and so on. When these conflicts are added to a host of others—state against state, "feds" against "locals," conservation versus profit—a council's deliberations can degenerate into combat. And the result can be contentious, ineffective management.

## The New England Case

In this respect, the New England council is recognized as by far the most troubled of the councils. Its management of herring, for example, has been bedeviled by conflicts between those who fish for juvenile herring (sardines) and those who go after the grownups. The latter naturally want the sardine catch kept small enough to ensure a robust "adult" herring fishery, and spokesmen from individual states vie with one another on behalf of their constituents. Perhaps the worst example, however, has been its management of groundfish—cod, haddock, and yellowtail flounder.

A bit more background is in order here. Soon after the fishery act was passed, NMFS prepared a full-scale management plan and prevailed on the New England council to adopt it so as to preclude unregulated fishing while



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the council was getting on its feet. This emergency plan became effective in March 1977. The plan (which, with myriad amendments, remained the basis of groundfish management until early this year) included catch limits, size restrictions, closed areas, mesh restrictions, and limits on "incidental catches"—in short, a serving of everything from the menu of traditional regulatory devices, except limits on effort. In mid-June, NMFS published final regulations implementing the plan. Just three weeks later, nonetheless, NMFS was compelled to close the cod fishery in the Gulf of Maine for the rest of the year. The reason: fishermen had already reached the 5,000 ton annual overall catch limit. In August NMFS extended that closure to all of New England, and in December to the entire groundfish fishery north of Cape May, New Jersey.

The next year brought more troubles. Having determined that the cod limit was about to be exceeded, NMFS closed the New England cod fishery on March 1, 1978, and a few days later, it closed all commercial fishing for both cod and haddock for the rest of the month. This forced some 1,700 vessels to shift to less desirable species.

In April, under pressure from small-vessel operators, the council and NMFS shifted to a system of "vessel class allocations," again by emergency regulation. Four classes were created: vessels under 61 gross registered tons, those between 61 and 125 tons, those over 125 tons, and those operating with fixed gear. Each class was given a separate quarterly limit (based on "historical landing data") for the Gulf of Maine and Georges Bank areas. This did not work either: by August 1978, NMFS had to close down the Gulf of Maine cod fishery again because all four classes had exhausted their allocations.

Nor have other groundfish species escaped problems. In February of 1979, over 300 angry fishermen, mostly from New Bedford, converged on a council meeting in Peabody, Massachusetts, to protest the closure of the western segment of the yellowtail flounder fishery.

In all these cases, the fishermen argued that there were plenty of fish and that the limits NMFS had insisted on were so unrealistically low as to guarantee economic hardship for the industry. NMFS, on the other hand, claimed its stock assessments were accurate, but that the council, pressured by its fishing constituencies, was simply unable to take adequate measures to hold effort to the requisite level. As one NMFS bureaucrat put it, "The council can agree about the size of the pie but has yet to say how many people can come to dinner."

The problems appear to have eased a bit, but the future is murky. On March 31, the New England council began trying out (once again under emergency regulations) a different way of managing groundfish, one that relies on spawning area closures and mesh regulations, rather than vessel classes and species catch limits. Moreover, having concluded that separate consideration of individual groundfish species is probably foolish because of the "mixed" nature of the fishery, the council and NMFS are hard at work on a plan embracing all groundfish. This is laudable. But whether the problems of the last five years can be overcome is anybody's guess. Mine is that considerable difficulties will remain, as conflicting interests jockey for position with one another, to the detriment of policy effectiveness.

### Biting the Bullet

So long as those who make policy for our coastal fisheries understand less than they need to about the resource they are trying to manage, fishery regulation will remain a messy, uncertain business at best. It must be admitted, however, that Congress has not been much help. It's approach seems to be "when in doubt, duck." Last May the House Committee on Merchant Marine and Fisheries reported out H.R. 5002, a bill that only tinkers with the real, if secondary, problem of the fishery act's cumbersome process. At least in New England, a much more serious problem than "process" has been that the council has failed to state its goals clearly, and as a result has allowed itself to be overpowered by the voices crying out for immediate relief. Unless Congress changes its approach, it will be up to NMFS to do what the act does not: face squarely the trade-off between adequate income for the industry and appropriate safeguarding of the long-term supply of fish. Unless the council begins drawing on *all* the tools at its disposal, including limiting effort, the fishery act is a poor substitute indeed for the uncontrolled rapacity of the foreigners. ■



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Regulation
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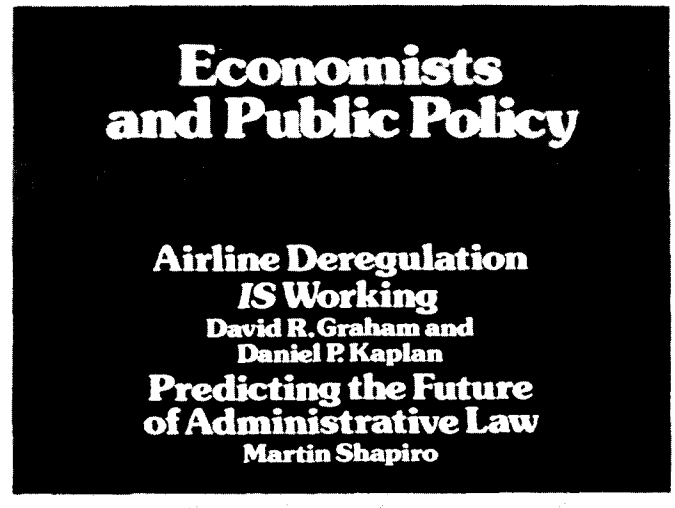
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# Readings
## of particular interest

### The Faults of No-Fault

"Insurance, Liability, and Accidents: A Theoretical and Empirical Investigation of the Effect of No-Fault Accidents" by Elisabeth M. Landes, in *Journal of Law and Economics*, vol. 25, no. 1 (April, 1982), pp. 49-65.

Between 1971 and 1976 sixteen states enacted "no-fault" laws restricting drivers' legal liability for damages arising from auto accidents. No-fault laws provide that up to some threshold of damage, each driver's financial losses will be reimbursed by his own insurance company.

The purpose of no-fault is to curb the high administrative costs of litigation by keeping all but the most serious cases out of court. Economic theory, on the other hand, predicts that limiting liability for damages will lead to a different kind of cost, by reducing drivers' incentives to exercise care. Since, under no-fault, drivers do not bear the full costs of reckless behavior, theory predicts that the enactment of no-fault laws will be followed by higher accident rates and greater accident losses.

The magnitude of this effect has been uncertain, however, and proponents of no-fault have argued that the savings in court costs outweigh any tendency toward more frequent accidents. Elisabeth Landes in this paper examines both the theoretical and the empirical relationship between no-fault and the frequency of auto accidents. Using a mathematical model of the way individuals choose how much care to exercise in driving, Landes demonstrates that if all losses were insurable, a compulsory insurance system could act as a substitute for a liability rule, so that a no-fault plan would not necessarily result in greater accident losses. Not all losses, however, are insurable; such intangible, noneconomic losses as "pain and suffering" are not reimbursed by insurers and can be recovered only if damage suits are permitted. Because no-fault laws limit compensable damages to economic damages only, Landes hypothesizes that they will indeed cause greater accident losses, even when insurance is compulsory.

Landes also hypothesizes that the effect of no-fault on accidents will be smaller where the insurance industry is concentrated. The reason is that, under no-fault, careless drivers impose costs on other drivers' insurance companies. As the insurance industry becomes more concentrated, it can more easily cooperate to charge these careless drivers higher premiums so as to reflect the costs they impose on insurers as a group. Individuals will thus "internalize" more of the externalities created by no-fault, which will induce them to drive more carefully. Where insurance is voluntary, however, this effect may not take place, since careless drivers who are not greatly risk-averse may choose to go uninsured rather than pay the higher premium.

Landes then submits both hypotheses to an empirical test. Because the sixteen states that adopted no-fault plans between 1971 and 1976 vary in the degree to which they restrict liability, they provide a natural data set for regression analysis. The degree to which liability is limited in each state is measured by three variables. One is the threshold of medical expenses below which an injured party may not file suit. (New Jersey's weak no-fault law, for example, has a threshold of only $200, while Minnesota's has a threshold of $2,000.) The second variable is the same threshold deflated by an index of local medical care prices in that state. The third is the proportion of 1979 insurance claims in each state in which the injured party was barred from bringing suit by the state's damage threshold. Landes also includes appropriate dummy variables in her regressions to represent the effects on accident rates of such factors as the age composition of a state and changes in the price of gasoline.



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Using statistics on fatal accident rates in the fifty states for the years from 1967 to 1976, Landes is able to estimate the actual effect no-fault has on the accident rate. With the exception of the states with the weakest no-fault laws—those whose damage thresholds were very low—no-fault seems to have a positive, statistically significant effect on fatal accident rates. Further, the magnitude of this effect increases with the stringency of the law: a medical expense threshold of $500 implies an increase in fatal accidents of about 4 percent, while a threshold of $1,500 implies an increase in fatal accidents of more than 10 percent. These results suggest that the states which enacted no-fault plans between 1971 and 1975 suffered between 376 and 1,009 additional fatal accidents as a result.

Landes's results also support her hypothesis concerning the interaction between insurance industry concentration and the effect of no-fault on accident rates. Using two measures of market concentration, she finds the effect of limited liability on fatal accident rates to be weaker when the level of industry concentration is higher.

## Farmland Losses: A Groundless Concern?

"The Urbanization of Agricultural Land: A Review of the National Agricultural Lands Study" by William A. Fischel, in *Land Economics*, vol. 58, no. 2 (May 1982), pp. 236-259.

The National Agricultural Lands Study (NALS) was established in 1979 by the Department of Agriculture and the Council on Environmental Quality to study the conversion of farmland to urban or other built-up uses. In its *Final Report*, issued in January 1982, the NALS charged that the conversion rate more than doubled between the 1960s and the 1970s, from around 1 million to more than 2 million acres a year. Projecting this trend into the future, the report expressed concern that the nation's supply of agricultural land might eventually prove insufficient to meet demand, at least at current prices. It recommended that federal, state, and local governments take steps to preserve agricultural land, primarily by restricting the growth of suburban and rural housing development.

In this paper William Fischel, professor of economics at Dartmouth College, argues that (1) the data on which the NALS based its alarm vastly overstate the true rate of urban development of rural land; (2) the market process already gives sufficient weight to preserving adequate farmland, making government intervention on this account unnecessary; and (3) the policies urged by the NALS will most likely harm the well-being of American households by giving parochial local interests specious reasons to restrict development.

Fischel's critique of the NALS figures takes three paths. First, the methods that local Department of Agriculture functionaries used to define and catalog urban and built-up land in the 1970s were significantly more inclusive than the methods used in the 1960s. Those methods may also have varied greatly from state to state, to judge by some of the anomalies in the data: South Dakota more than doubled its reported "urban land area" despite its low rate of population growth, while Kansas and three other states had *negative* reported rates of urbanization.

Second, the NALS report's claim that the rate of urbanization doubled in the 1970s is not borne out by data on construction. Home building increased only 12 percent and new road mileage only 13 percent from the 1960s to the 1970s. Moreover, evidence suggests that the houses built in the 1970s used less land on average.

Third, aerial photos indicate that the level of urban development is far below what the NALS claims. Data from U.S. Geological Survey high-altitude mappings of urban and built-up land are available for four states. The Department of Agriculture figures exceed the Geological Survey figures by 29 percent in Pennsylvania, 41 percent in West Virginia, and 74 percent in Florida. Only for Kansas (where the department had shown a decline in urban land area) did the two sets of data approximately agree. Moreover, a study for the department's own Economic Research Service by Kathryn Zeimetz and others found that from 1960 to 1970 urbanized land increased by only 23 percent in the fastest-growing large counties in the country—compared with the NALS estimate of a 47 percent increase in urban land *for the en-*



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*tire country* in the period 1967–1977. Fischel concludes that "the figures used by the NALS overstate the conversion of rural land by a factor of two and quite possibly by a factor of three or four."

Even if urban development were proceeding at the rate the NALS claims, Fischel says, there would still be no cause for alarm—if only because the "baby boom" generation is now passing the peak age for household formation. If every family of four in the United States were housed at the suburban "sprawl" density of one home per acre, only 3 percent of the U.S. land area—not counting Alaska—would be taken up. "Urbanized areas," which housed about 58 percent of the U.S. population in 1970, take up about 1.2 percent of the U.S. land area. The author reviews three economic models of the process of rural land development, examining such factors as the alleged irreversibility of development, government subsidies for suburban sprawl, speculation, "leapfrogging," and the "impermanence syndrome." He concludes that none of these factors has an important effect on the amount of land available for agriculture now or in the future.

There are, of course, real conflicts among users of land. Suburban residents, for example, often object to the insecticides and noisy machinery associated with farm use. (Fischel notes the irony that environmentalists have been in the forefront of support for "right-to-farm" laws that prevent agricultural pollution and noise from being attacked in the courts as nuisances.) But in Fischel's view these disputes do not require federal or even state intervention, since their effects are largely localized. He believes that artificial nationalization of these issues of land use is seriously harmful. Even when the battles are fought exclusively at the local level, suburbanites who have already "got theirs" find the "protection" of farmland a nearly perfect means of excluding newcomers. But if farmland preservation is turned into a false national issue, the inequitable possibilities of exclusionary zoning are vastly expanded. Reports that the country is running out of farmland have already had a significant influence on state and local zoning and land use decisions—an effect that Fischel believes has needlessly harmed people who want to live and work in new developments, and consumers in general.

## Mergers and Concentration: The Empirical Evidence

*Mergers in Perspective* by Yale Brozen (American Enterprise Institute, 1982), 88 pp.

"If nothing is done to check the growth of concentration," to quote a 1948 Federal Trade Commission report, "the giant corporations will ultimately take over the country." The commission's warnings about the dangers of unchecked mergers did not go unheeded: in 1950 Congress passed the Celler-Kefauver amendment to the Clayton Act, which prohibited corporate acquisitions "where . . . the effect of such acquisition may be substantially to lessen competition, or tend to create a monopoly." Despite the narrow scope of its prohibition, the amendment greatly stimulated federal antimerger enforcement. The difficulty of determining what constitutes an anticompetitive merger led the Department of Justice and the courts to rely on market share standards. Eventually, in 1968, the department published explicit merger guidelines that established market share thresholds above which mergers would be challenged. (See Joe Sims and William Blumenthal, "The New Era in Antitrust," p. 25.)

Yale Brozen, professor of business economics at the University of Chicago, here challenges the notion that merger activity has an appreciable or lasting effect on concentration. He finds that horizontal mergers have not caused concentration to increase and that conglomerate mergers have had no effect on aggregate concentration or on the number of firms in particular industries. Moreover, says Brozen, much evidence supports the view that conglomerates enjoy economies not available to firms operating separately and that mergers are an intrinsic part of the process by which productive resources come to be used efficiently. Because of the gains from mergers and the loose connection, at best, between mergers, concentration, and losses due to monopoly power, the author advocates basing merger policy on the underlying economics of industry structure instead of the arithmetic of market shares.

Even though merger activity continues to be substantial, Brozen finds little support for the view that the U.S. economy is becoming more concentrated, either in particular indus-



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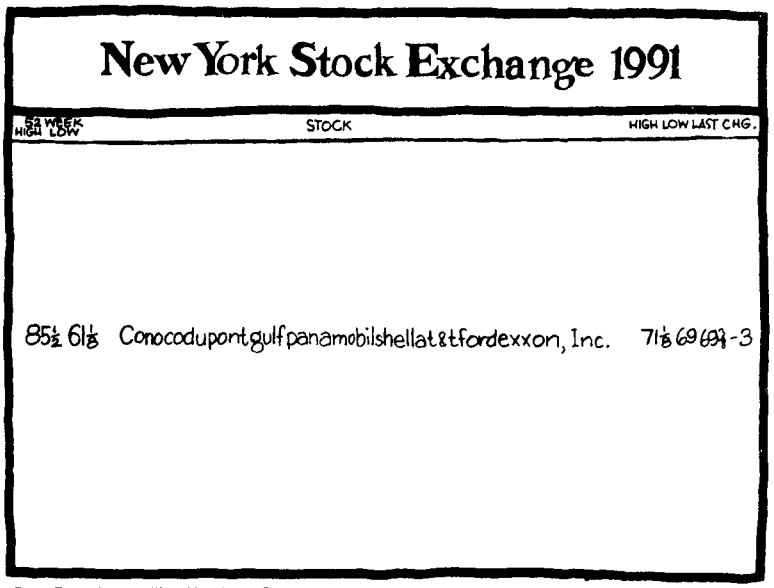
tries or in the aggregate. For example, the percentage of shipments made by industries with four-firm concentration ratios above 60 percent rose from 20.9 in 1935 to 21.8 in 1972, but then fell to 19.8 in 1977, according to Census Bureau data. (Because the Bureau used a different number of industrial categories in 1935 than in 1972, the actual percentage probably declined over that period.)

Aggregate concentration, or concentration in the economy as a whole, is often alleged to be increasing because of lax conglomerate merger policy. It has, however, shown no clear trend. The percentage of shipments accounted for by the 200 largest industrial companies rose from 41 to 45 percent between 1937 and 1977, but the share of shipments for the 50 largest industrials fell from 28 to 25 percent over the same period. And, Brozen notes, imports are playing an increasing role in the market for manufactured goods, which makes effective concentration lower. Assets are more concentrated than sales, but manufacturing assets are a relatively small fraction of total assets. A broader measure is that of all nonfinancial corporations: the 200 leading firms of this type held 57 percent of all nonfinancial assets in 1933, but the figure has declined steadily to 39.5 percent in 1975.

Interestingly, the 1948 FTC report's claim that economic concentration was rising, which helped bring about the Celler-Kefauver amendment, cannot be substantiated by the figures, as many contemporary observers noted at the time. Although more than 2,000 firms were absorbed through merger between 1940 and 1947, 62 percent of them in horizontal mergers, average four-firm concentration fell from 41.8 percent in 1935 to 39.7 percent in 1947. (It fell still further to 38.4 by 1977.) The most notable development in industry concentration since then, apart from the stability of the figures as a whole, is the tendency of highly concentrated industries to become less so and less-concentrated industries to become more so. Of industries with four-firm concentration ratios above 50 percent in 1947, about two-thirds declined in concentration by 1977.

Brozen says that these and other statistics support the view that the long-term structure of an industry is determined by overriding economic forces, not by who buys whom. Yet policy makers often presume that blocking mergers will advance the vague ideal of deconcentration. The courts, for example, have frequently barred acquisitions on the theory that would-be acquirers would otherwise enter the industry on their own. This presumes, Brozen says, that the motive for entry is the desire to move into a specific line of business. Recent empirical work strongly suggests, however, that the motive for conglomerate merger is often to acquire a poorly managed firm, usually at a substantial premium, and then rejuvenate it. Moreover, firms that become targets in acquisitions tend to have suffered previous declines in their stock market value relative to other firms.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Sometimes mergers lead to savings because firms can carry out some processes internally better than they can through the market. The sharing of proprietary information, for example, can be conducted within a firm when it would not be risked with outside firms. Also, legal costs per dollar of sales are substantially lower for large firms, which suggests that large firms substitute internal mechanisms for complex or risky transactions. If the net gains from increased firm size are large, but acquisitions are made impossible, concentration will arise through other means. Some firms will be



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run out of business, and society will incur the needless expense of duplicating their assets, either through the internal expansion of one of the surviving firms or through new investment by a diversified firm.

Brozen says the "negligible" effect of mergers on long-term concentration should generally not outweigh their demonstrated capacity to increase efficiency. He advocates a neutral policy, one that neither hinders vertical, conglomerate or most horizontal mergers, nor artificially encourages them.

## A Price Tag on Jet Noise

"Charges to Control Aircraft Noise" by Donald C. Cell, in *Environmental Policy Implementation*, edited by Dean E. Mann (Lexington Books, 1982), pp. 157-171.

Like other forms of pollution, the noise that airports inflict on their surrounding neighborhoods is now subject to direct "command-and-control" regulation. The Federal Aviation Administration has promulgated noise standards for aircraft under the Noise Control Act of 1972, which specifies that each standard is to be "economically reasonable" and "appropriate" for the particular type of aircraft or aircraft engine involved. Such airports as Washington National have imposed curfews on night operations under pressure from groups of local residents.

Donald Cell, professor of economics at Cornell College in Iowa, maintains that aircraft noise is a good candidate for an "emissions-fee" approach, one reason being that "the cost of acquiring the information needed to administer aircraft-noise charges would be unusually low." Cell offers sample schedules of noise charges, developed by the now-defunct Council on Wage and Price Stability, that he says would be easy to implement and likely to lead to significant savings.

Cell begins with an account of the reasons economists tend to favor emissions-charge schemes. Only the "polluters" themselves, who in this case are airlines and airports, know how to reduce noise most inexpensively. The best way of achieving any given reduction is likely to be a mix of measures such as buying new aircraft, rescheduling flights, and using outlying airfields. If an airline must pay a sliding fee based on the amount of damage its noise inflicts on nearby residents, its management will pick the cheapest means to reduce noise, and will pursue the reduction to a point below which the cost to the airlines would exceed the value to the neighbors.

Command-and-control regulations sometimes seek to mimic this sort of efficiency by "fine-tuning" the rules to take into account costs and benefits. Logan International Airport in Boston, for example, discourages passenger traffic at night more than freight traffic, on the view that the former is generally cheaper to reschedule than the latter. The FAA aircraft standards, likewise, vary according to an aircraft's number of engines, weight, and date of design and construction. Yet such discrimination among classes of aircraft or flights, while of some help, still fails to minimize costs. The problem is that both the costs and the benefits of reducing noise vary greatly within the classes that the regulations have been able to distinguish. The cost of noise-dampening gear may be justified if a given craft is to be used for night service between big cities, but not for day service between sparsely settled points. Some late-night passenger trips may be worth their cost in noise and some late-night freight shipments may not.

"Economic theory," Cell notes, "distinguishes between two efficiency goals: promoting the least expensive methods of abatement and achieving the right level of abatement." To determine the right level of abatement, it is necessary to come up with some estimate of the harmful effects of noise. One such measure is the difference in property values between homes near airports and similar homes located elsewhere. Arguably, the difference represents the valuation that average homeowners actually place on quiet; had the homeowners living near the airport really placed a higher valuation on quiet than that difference, they would presumably have willingly paid the premium needed to live elsewhere. The Council on Wage and Price Stability in 1977 calculated for twenty-three airports the total loss of rental value of surrounding property due to noise, and divided it by the number of airline takeoffs and landings during the year. The highest resulting average cost per operation was $196.67 for New



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York City's La Guardia Airport. Costs were also high for the other New York City airports and Logan in Boston. At the low end was the Portland, Oregon, airport, with a typical noise cost of just 82 cents per operation, and Dulles near Washington, with a cost of $5.64.

Noise charges would vary not only from airport to airport, of course, but from flight to flight. Acoustical experts have developed a subjective measure called "effective perceived noise" that takes into account the loudness, duration, and shrillness of the sound made by an aircraft. According to FAA data, the effective perceived noise emitted by ten types of aircraft in use during the mid-1970s ranged on this index from a low of 92 for a Boeing 737 on takeoff to a high of 116.8 for a Boeing 707 (without "retrofitted" noise-control gear) on landing. Cell says that a fee schedule should make airlines pay for all noise they make that is deemed to contribute significantly to raising the local noise level above the tolerable threshold. The council's illustrative calculations for Logan International Airport show that for day flights an aircraft with an effective perceived noise index of 97 or less would not exceed the threshold and would thus pay no fee. Above an index of 97, charges would rise rapidly. A plane would pay $41.09 if it ran at a noise index of 100, $216.79 at a noise index of 112, and $433.61 at a noise index of 117. Night noise would be twelve times as costly as day noise, so that the fee for a plane with a 117 index landing at night would be $5,202.48.

Cell concedes that some might consider such a charge scheme flawed "because noise monitoring is still imperfect, because the day-night differential is somewhat arbitrary, because not all airports that have a noise problem may be induced to adopt the same rate of charge per unit of noise, and so forth." But, Cell says, "any noise-control policy that aspires to cost-effectiveness must cope with [the] same problems. . . . [S]uccess is a matter of degree."

On the positive side, Cell contends, there are three reasons why noise charges should prove relatively easy to implement. Noise is largely confined to the immediate vicinity of the airport, the methods for monitoring noise are well established and inexpensive, and each airport would need to settle accounts with only a handful of companies.

## Public Regulation and Private Enforcement

"Public Programs and Private Rights" by Richard B. Stewart and Cass R. Sunstein, in *Harvard Law Review*, vol. 95, no. 6 (April 1982), pp. 1193-1322.

The courts have created a number of different remedies to allow private persons to prevent unlawful acts by government agencies. If an agency tries to regulate a private person who is allegedly polluting, for example, that person can go to court to test the legality of the regulation. If an agency fails to prevent pollution, courts have sometimes allowed private persons to file suit to compel the agency to act. Courts have also allowed private persons to bypass the agency and sue the alleged polluter directly (the so-called private right of action). And, in a series of decisions, the courts have held that private persons have a constitutional right to a hearing when they are deprived of certain statutory benefits, such as payments under state welfare programs.

These various remedies are usually studied separately, but they pose some common problems that make them all highly controversial. When courts create private rights of action, for example, they may allow private persons to circumvent a public enforcement system, disrupting the agency's ability to make law and policy and undermining political controls on enforcement.

In this article, Professors Stewart (of Harvard Law School) and Sunstein (of the University of Chicago Law School) analyze these different remedies in an effort to develop a general theory to explain judicial creation of remedies for faulty regulation. They emphasize that judicial creation of such remedies raises serious separation-of-powers questions, and that private remedies may sometimes interfere with regulatory programs. Nonetheless, they argue that judge-made remedies are a justifiable response to the disruption of the constitutional structure caused by the creation of administrative agencies that combine traditionally separated powers and are often not subject to effective electoral control. In these circumstances, the authors maintain, private remedies can serve as a "second-best" substitute for the original safeguards achieved by the constitutional system of checks and balances.



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In particular, Stewart and Sunstein examine private remedies as means of securing three of the purposes served by regulation: protecting private entitlements, expanding production or "efficiency," and advancing public values through an open and democratic policy-making process. They attempt to show that each of the various private remedies is meant to promote one of these three basic goals. As a result, they maintain, the creation of such remedies is a justifiable exercise of judicial power. While acknowledging that it would often be preferable for Congress or the executive branch to assert greater control over regulation, the authors conclude that judge-made private remedies are frequently desirable because they simultaneously improve the administrative process and promote some of the goals that underlay the original constitutional framework.

## Utility Rates: Two Case Studies

*Regulatory Politics and Electric Utilities: A Case Study in Political Economy* by Douglas D. Anderson (Auburn House, 1981), 191 pp.

Douglas Anderson, associate professor at the Harvard Business School, seeks to "take a fresh look at regulatory behavior" by examining state regulation of electric utilities from 1968 to 1978. He concludes that the "capture" theory of regulatory behavior is inadequate to explain the recent history of utility regulation, and that a broader typology of regulatory behavior is needed.

To be sure, there is an element of "capture" in the origins of regulation in the industry. It is part of "the folklore of regulation," Anderson says, that state laws regulating public utilities were passed over the utilities' strenuous objections. In fact, power company executives were "committed to the concept of state regulation" on the grounds that it would provide "absolute stability of our securities and protection from unnecessary competition," as an official of the Southern California Edison Company put it. In addition, utilities preferred state regulation to dealing with municipal regulators or risking municipal ownership of utilities.

Even after regulation had been in place for some years, it was still no threat to utility interests. Regulators promoted electricity usage through rate structures in which the unit cost of electricity declined with increased usage. This led to rapid growth in demand, which paved the way for utilities to build larger generating plants and reap savings from economies of scale. With stable or declining rates and reliable service, smaller consumers had little reason to pay attention to utility regulation, and planning and pricing decisions were largely left up to the industry.

In the late 1960s and 1970s, that began to change. Under the spur of inflation and higher fuel prices, the utility industry deluged state regulatory commissions with rate hike requests. Only three states had carried out general rate reviews in 1963; that number rose to 19 in 1969 and 114 in 1975. Some states granted fuel adjustment clauses, which let utilities pass along escalating fuel costs without an additional hearing. Electricity rates rose 90 percent nationwide from 1970 to 1975. At this point other interested groups began to enter ratemaking proceedings in force. Environmentalists and Federal Energy Administration experts favored rates that varied according to the time of use and the marginal cost of production. Both groups hoped to reduce the demand for electric power, the first as a way to avoid building new power plants, the second as a way to conserve energy. Consumer groups, meanwhile, began to organize campaigns to stop rate increases. They too sought to revise the system of declining volume rates—not in order to make each customer pay the marginal cost of service, but in order to make commercial and industrial users subsidize smaller residential users through "lifeline" rates.

The author details two case studies in which state ratemaking took very different directions: New York, which adopted marginal-cost-based electric rates, and California, which adopted "lifeline" rates. In New York, the political struggle for rate reform was led by the commission's chairman, economist Alfred Kahn. Kahn first won the support of the commission staff, many of whom were engineers new to economic ways of thinking. Then, after the commission had been brought to approve the general idea of marginal-cost pricing, it took up a specific request by the Long Island Lighting Company to restructure the rates it charged its largest commercial and industrial



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customers. By then utilities, environmentalists, residential customers, and FEA experts were all supporting marginal-cost pricing, but Kahn still had to win the approval of large industrial users. The eventual rate structure approved for Long Island Lighting was a compromise of marginal-cost principles: it was agreed that no class of consumer would have to pay more than it had under the old ratesetting method. Even though the new rate structure did not differ greatly from average-cost pricing, it was considered a major innovation.

In California, rate revision took a much different path. Leonard Ross, Governor Jerry Brown's first appointment to the California Public Utility Commission, behaved as a "political entrepreneur," Anderson says, in leading an effort on behalf of lifeline rates. Paying no heed to the commission staff's opposition to the scheme, he devoted his energies to developing external support from coalition groups claiming to speak for the poor and elderly, residential consumers, labor unions, and environmentalists. Eventually the commission was persuaded to endorse the plan, and lifeline rates were subsequently approved in September 1975 by the California legislature.

New York, Anderson says, is an example of a "bureaucratic" style of regulatory behavior. Ongoing staff involvement and cooperation is needed to formulate and implement a marginal-cost pricing policy, which means that internal organizational harmony is essential. California, on the other hand, is an instance of "entrepreneurial" regulatory behavior, the author says. A lifeline rate structure, unlike marginal-cost pricing, takes little effort to manage once it is installed. Thus it is suited to an "issue campaign" strategy in which the marshaling of outside pressure takes the place of internal agency support. Neither state, he adds, is an example of "capture," since in both cases regulators faced more than one active external pressure group.

*The summary of* Social Regulation: Strategies for Reform *included in our last issue (May/June 1982, pp. 54-55) omitted mention of one of the authors, Michael H. Levin of the Environmental Protection Agency, who contributed the chapter entitled "Getting There: Implementing the 'Bubble' Policy." We regret the error.*

**A Green Light for Trucking Efficiency**

*(Continued from page 42)*

ed in getting restrictions removed from their authorities, leaving them freer to shorten circuitous routes, to serve intermediate points on those routes, and to haul a more broadly defined group of commodities. All of this, of course, increased efficiency and competition.

### A Summary of Effects

The net result of administrative and legislative reform is a more competitive and more efficient industry, with lower prices (rates) and better service for consumers. While some part of the lower rates may be attributed to the economic downturn, the loss in the value of operating rights and the unprecedented increase in independent rate proposals are strong evidence that the downturn is not solely—indeed, is not mainly—responsible. The amount and quality of service to small communities seems to have risen, and increases in entry and new authority grants signal a less concentrated industry.

It will be several years before we can make a complete assessment of the long- and even short-term effects of trucking regulation reform. But the weight of the evidence seems to support the arguments made by the outside observers, that regulatory reform would benefit consumers—in other words, would benefit society as a whole. It is our belief that the burden of proof is squarely on those who would argue the contrary. ■

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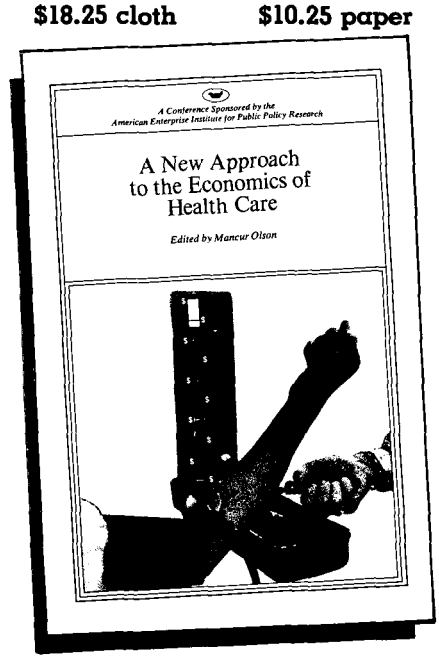
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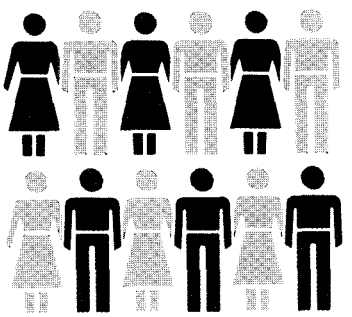

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